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CORPORATE TAX SHELTERS

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

NOVEMBER 10, 1999

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CONTENTS

Page

Advisories announcing the hearing 2

WITNESSES

U.S. Department of the Treasury, Jonathan Talisman, Acting Assistant Secretary for Tax Policy 24
Joint Committee on Taxation, Lindy Paull, Chief of Staff 37

American Bar Association, and Orrick, Herrington & Sutcliffe, Paul J. Sax 60
American Institute of Certified Public Accountants, David A. Lifson 68
BellSouth Corporation, and Tax Executives Institute, Inc., Charles W. Shewbridge, III 73
Doggett, Hon. Lloyd, a Representative in Congress from the State of Texas 8
Hariton, David P., Sullivan & Cromwell 124
Kansas City Southern Industries, Inc., Danny R. Carpenter 135
New York State Bar Association, Harold R. Handler 86
PricewaterhouseCoopers, Kenneth J. Kies 101
Tax Analysts, Martin A. Sullivan 126

SUBMISSIONS FOR THE RECORD

Association of the Bar of the City of New York, Andrew H. Braiterman, letter and attachment 152
Massachusetts Mutual Life Insurance Company, Springfield, MA, statement .. 160
Millman, Stephen L., New York, NY, and Steven C. Salch, Houston, TX, Fulbright & Jaworski L.L.P., statement 161
Washington Counsel, P.C., and Tax Fairness Coalition, statement 166

CORPORATE TAX SHELTERS

WEDNESDAY, NOVEMBER 10, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to call, at 11:00 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisories announcing the hearing follow:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE
October 26, 1999
FC–14

CONTACT: (202) 225–1721

Archer Announces Hearing on Corporate Tax Shelters

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on corporate tax shelters. **The hearing will take place on Wednesday, November 10, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

Oral testimony at this hearing will be from both invited and public witnesses. Invited witnesses will include representatives of the U.S. Department of the Treasury and the Joint Committee on Taxation. Also, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee or for inclusion in the printed record of the hearing.

BACKGROUND:

Section 3801 of the Internal Revenue Service (IRS) Reform and Restructuring Act (P.L. 105–206) required the Joint Committee on Taxation and the Treasury to each conduct a separate study reviewing the interest and penalty provisions of the Internal Revenue Code, and make any legislation and administrative recommendations deemed appropriate to simplify penalty administration and reduce taxpayer burden, by July 22, 1999. On July 1, 1999, the Treasury released a "white paper" on corporate tax shelter penalties and related issues, but did not deliver the broader penalty and interest study. The Joint Committee on Taxation issued its recommendations on penalties and interest and corporate tax shelters on July 22, 1999. On July 13, Chairman Archer announced his intention to hold a hearing on corporate tax shelters after the Treasury had completed its penalty and interest study. That study, including additional recommendations which could affect corporate tax shelters, was received yesterday. There is little agreement as to the definition or extent of corporate tax shelters, or the proper governmental response to them. The hearing will address the various policy issues related to corporate tax shelters as well as possible administrative or legislative responses.

In announcing the hearing, Chairman Archer stated: "This hearing is the latest in the Committee's efforts to stop abusive tax shelters. Due to actions taken by Congress since 1995, we have stopped $50 billion in tax abuses. The IRS has won case after case in tax court using the very tools Congress already provided. Now, our challenge is to focus efforts on stopping abuses while properly restraining new blanket authorities for the IRS that might chill legitimate business transactions. This hearing continues the Committee's efforts to strike the proper balance in addressing the problems presented by corporate tax shelters."

FOCUS OF THE HEARING:

The hearing will focus on (1) the nature and scope of the perceived corporate tax shelter problem, (2) the manner in which the IRS and the courts are currently addressing corporate tax shelters, (3) additional steps the Administration could take under current law to address such shelters, (4) additional legislation which might be necessary to address corporate tax shelters, and, (5) procedures the Administration has in place or could adopt, or that the Congress could enact, to ensure that new or existing enforcement tools brought to bear on corporate tax shelters do not

interfere with legitimate business transactions or make more difficult the application of an already complex income tax.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Pete Davila at (202) 225–1721 no later than the close of business, Wednesday, November 3, 1999. The telephone request should be followed by a formal written request to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Committee will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff at (202) 225–1721.

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE-MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record, in accordance with House Rules.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies, along with an *IBM compatible 3.5-inch diskette in WordPerfect 5.1 format*, of their prepared statement for review by Members prior to the hearing. **Testimony should arrive at the Committee office, room 1102 Longworth House Office Building, no later than Monday, November 8, 1999.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should *submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label,* by the close of business, Wednesday, November 24, 1999, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. **Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.**

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'http://www.waysandmeans.house.gov".

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

*****NOTICE—CHANGE IN TIME*****

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721

November 5, 1999

No. FC-14-Revised

Time Change for Full Committee Hearing on Wednesday, November 10, 1999, on Corporate Tax Shelters

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the full Committee hearing on corporate tax shelters, previously scheduled for Wednesday, November 10, 1999, at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, will begin instead at 11:00 a.m.

All other details for the hearing remain the same. (See full Committee press release No. FC–14, dated October 26, 1999.)

Chairman ARCHER. The Committee will come to order.

The Chair invites all of our guests to take seats.

This morning's hearing continues on the ongoing efforts of the Ways and Means Committee since 1995 to address issues relating to corporate tax shelters and any possible abuses in the Code.

Over the past several years, the Congress has enacted a number of changes to prevent abusive corporate tax shelters, and those

changes have included specific provisions addressing at least $50 billion of known abuses. They also included general changes requiring the registration of corporate tax shelters and enhancing the substantial understatement penalties for such shelters.

I have been disappointed that the Treasury Department has failed to implement the corporate tax shelter registration provisions that it requested in its own budget. I personally believe this failure is inexcusable and has contributed to the perception that the government doesn't care about aggressive corporate tax shelters, and that is simply not the case.

There are a number of other steps that Treasury and the IRS could take under current law to address the problems of corporate tax shelters, and I look forward to a discussion of those options. I also look forward to discussion of potential legislative proposals.

The primary focus of this Committee in considering legislation and addressing corporate tax shelters will be to ensure that any new laws we enact do not end up interfering with legitimate business transactions or making substantive changes in tax law that have not been adequately considered through hearings and, furthermore, that we should make every effort not to make the Code more complex.

Now, maybe that is an oxymoron relative to any income tax code, I am not sure, but we should make every effort to do that.

With that, I recognize Mr. Rangel for any opening statement that he might like to make.

Mr. RANGEL. Thank you, Mr. Chairman.

I am still one of those faithful believers that at some point before we end this session that we are going to pull the IRS Code up by the roots. The last 5 years we have heard a lot of talk about how complicated this system is. And I think you have to agree with me that no matter what you want to call these provisions that we are studying today, that in no small part they are responsible for much of the complexity that we find in the Tax Code, which is merely treating people differently because of our desire to have an outcome which we direct by the way we give credits and deductions.

Now I know that Treasury has not done all that it can do. It is never the case that they do. But we have had recommendations to stop abusive corporate tax shelters made by the Treasury Department and recommendations by the American Bar Association. We have had magazine articles. And we have certainly had Congressman Doggett, who has brought to the attention of the Congress and the Nation the fact that we have a lot of things in our Tax Code that should be removed such as tax shelters.

I have a letter here from the National Association of Manufacturers saying that we should attack illegitimate corporate tax loopholes. And so this is the eleventh hour. I don't know what we can accomplish between now and Christmas, but there must be a reason why we are having this hearing so late in this year.

We did have an opportunity with the $792 billion tax cut to reform the system as we decorated the Christmas tree, but it wasn't done then. So I don't know what this hearing is going to do except to painfully point out what we haven't done. But being a faithful soldier, I follow your leadership and congratulate the Chairman for

recognizing that within our corporate tax structure we have tax shelters that should not exist.

I believe you when you say that we are not going to make dramatic changes without hearings and finding out what impact tax changes would have. When we will do this, I don't know. But I am here to find out and to welcome our colleague, Mr. Doggett, and to thank you for having the hearing before we adjourn tonight.

Thank you, Mr. Chairman.

[The opening statement of Mr. Rangel follows:]

Statement of Hon. Charles B. Rangel, a Representative in Congress from the State of New York

1. The Committee is *finally* meeting to discuss the huge problem of abusive corporate tax *shelters.*

- Unfortunately, this important issue is being addressed by a hearing—not a *markup*-at the time the *Congress is preparing to adjourn*.
- Obviously, Republicans *don't consider* corporate tax shelters a *serious problem*. If they did, they would have acted by now or *at least have a plan*.
- There is *no question* that corporate tax shelter abuse is a widespread and major problem and *could have been solved months ago.*

2. Just last week it was reported that *corporate tax shelters may be having a substantial negative impact on corporate tax receipts.*

- Corporate tax *receipts* for fiscal year 1999 were approximately $4 billion *less* than for fiscal year 1998—even though corporate *profits* for 1999 were approximately $20 billion *higher* than in 1998.
- The decline in corporate tax receipts in fiscal year 1999 was the *first decline in recent history* that was not caused by explicit congressional reductions in corporate taxes or declines in the overall economy.
- Corporate tax receipts as a percentage of corporate profits have *steadily declined* in recent years from approximately 26.6% in 1994 to 21.8% in 1999.
- This *decline* has occurred *despite the corporate rate increase* in the 1993 budget act and despite net corporate tax increases enacted since 1994.
- If corporate receipts had remained constant as a percentage of corporate profits since 1994, corporate tax *receipts* in fiscal year 1999 would have been at least *$40 billion higher*.
- High among the list of *suspected causes* for the decline in corporate tax receipts is the *increased use of aggressive corporate tax shelters.*

3. *Congressman Doggett* (the first witness) should be commended for his continued *leadership* in highlighting the corporate tax shelter abuse problem and for proposing a meaningful *solution*.

- His bill, H.R. 2255, the "Abusive Tax Shelter Shutdown Act of 1999" would *disallow tax benefits from transactions without substantial economic substance* and *increase the penalty* for substantial tax understatements.
- His bill is *based on the recommendations made by the Treasury Department and the American Bar Association*. While the details of their proposals may vary, their goal is the same.

4. Over the past six months, *Republicans have refused* to consider or support corporate tax shelter reforms.

- Some (Archer) have said that Congress *needed "to wait"* for Treasury's overall study on interest and penalty reform (released in October 1999.) This was *just an excuse for doing nothing.*
- In fact, Treasury's October interest and penalty report does *not* address corporate tax shelter abuse.
- Moreover, *in July 1999,* Treasury issued a comprehensive *report on corporate tax shelter abuse.* The Joint Committee on Taxation issued their report on interest, penalties and tax shelters at the same time. *Both reports* make recommendations for legislative action, yet nothing has been done.
- Rather than consider H.R. 2255, or the other proposals made by the tax community professionals, *the Republicans have chosen to invent ridiculous revenue raising proposals*—such as delaying payment of the Earned Income Tax Credit—which would hit hardworking Americans who pay highly regressive payroll taxes.
- Obviously it is easier for the Republicans to *hit on the working guy,* rather than to *attack corporate tax abuse* and the *peddlers* of tax shelter transactions. (The Republicans say they don't know how EITC beneficiaries spend their money and that those working families need help managing their financial affairs-maybe it's time

that the Republicans help corporate lawyers and accountants in ethically managing their affairs.)

• For the first time in Committee history, failure to act on tax shelters has *left the tax community criticizing the Committee* for not acting expeditiously to stamp out aggressive, abusive corporate tax loopholes.

5. It is unfortunate that we will *hear little today about the real facts and players*—who the marketeers of abusive tax shelters are, the effectiveness of their marketing techniques, the purpose and goal of the deals they cut, the outrageousness of the transactions being "peddled," how they get away with it, and the "big bucks" at stake.

• The recent *Forbes* magazine cover story titled "The Hustling of X Rated Shelters" documents how the "Big Five" accounting firms and major law firms are competing aggressively to bring the next corporate tax scheme to market.

• Tax professionals are "*cold calling*" potential corporate clients, offering tax shelter schemes for 10% of the tax savings, and requiring pledges of "confidentiality."

• For example, we understand that a company received *unsolicited offers* for a tax shelter scheme after the press reported that the company would have large capital gains that year.

• The "*peddling*" of abusive tax breaks to corporations is not only *unethical*, but also threatens the heart of our tax system.

6. Under current law, there is a *court-developed doctrine* that requires transactions to have *economic substance* in order to be respected for tax purposes.

• H.R. 2255, introduced by Congressman Doggett, *codifies the judicial "economic substance"* doctrine so that transactions must have potential for profit/risk of loss and potential profit must be significant in relationship to the tax benefits.

• The ABA, NY State Bar Association, and Treasury *support* this reform.

7. Also, current law includes an "accuracy-related" *penalty for tax understatements* equal to 20%. The penalty does not apply where the taxpayer has reasonable cause (such as having a legal opinion) to justify the transaction.

• H.R. 2255 would increase the substantial understatement penalty from 20 to 40 % *for transactions without substantial economic substance.*

• The bill would not allow an easily-obtained legal opinion to protect a sham transaction or avoid sanctions.

8. The provisions of H.R. 2255 have been used as a *revenue offset in Democratic "substitutes"* to the 1999 tax cut bill, managed care reform bill, and tax extenders package.

• JCT estimates that the bill *raises $10 billion* over 10 years.

Chairman ARCHER. I thank the gentleman for his statement.

I am constrained to respond briefly by saying that the gentleman refers as to his desire to tear the income tax out by the roots and join me in that effort, and the Chair waits with anticipation for the gentleman's endorsement of any plan to do that, even conceptually, which the Chair has not yet heard. But I hope that that day will come where the gentleman from New York will endorse some conceptual plan at least, if not in statutory language, in order to accomplish that, and we will welcome him joining me in that effort.

As far as not knowing when we will begin to address the corporate tax shelter problem, that is precisely what the Committee is about today. The when is now.

The Chair is happy not to welcome, because the gentleman is here almost every day as he is regular in his attendance at Committee meetings, but to have as our first witness my fellow colleague from the State of Texas, Mr. Doggett, to tell us about his proposal to address the corporate tax shelter problem.

Mr. Doggett, we are happy to receive your testimony.

STATEMENT OF THE HON. LLOYD DOGGETT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. DOGGETT. Mr. Chairman, thank you very much for your Texas hospitality and your continual courtesy to me as a brand new member of this Committee.

Mr. Rangel and members of the Committee, I appreciate the opportunity this morning to focus some attention specifically on H.R. 2255, the Abusive Tax Shelter Shutdown Act, that I introduced back in June, I believe. It is the only legislative proposal pending in Congress concerning this matter.

And I would simply summarize my written testimony about it and request that that written testimony be made a part of the record.

I sincerely believe, Mr. Chairman, that the rampant spread of corporate tax shelters and our inattention to it in this Congress represents one of our major shortcomings. The proliferation of abusive corporate tax shelters is costing the Federal treasury literally billions of dollars.

A professor named Michael Graetz defined a tax shelter in terms that I could understand it, as saying it is a deal done by very smart people that, absent tax considerations, would be very stupid.

And when one of these apparently stupid schemes gets shut down, more seem to blossom, and I think that is not by accident. One Big Five accounting firm reportedly requires its very smart staffers to come up with at least one of these economically foolish but tax wise corporate tax dodge ideas each week.

The literal hustling of improper tax shelters is so commonplace that one representative of a major Texas-based, multinational corporation reported to my office recently that he gets a cold call every day from someone hawking these shelters. Some are even called black box proposals. They are kept under wraps and not even generally discussed with anyone other than just a few of the select corporate clients.

As a partner at one of these national firms boasted, "A whale can't get harpooned unless it surfaces for air." To me, that is a rather whale-sized bit of arrogance toward the ordinary taxpayer, corporate and noncorporate, who is out there trying to comply with the tax law and honestly file their tax return.

I believe that these taxpayers, businesses and individuals, get hit in two ways by our failure to address this problem. First, they end up having to make up the revenues that those who cheat on their taxes don't provide; and, second, they have to pay for the very expensive law enforcement necessary to try to seek compliance.

One of these tax shelter cases that was won this summer cost the public about $2 million for victory. Amazingly, though we have had some success, and though this Committee prior to my coming on it has acted in this area, the fact that there is a victory here or there doesn't seem to slow the process of new tax shelters. It seems to me that these tax shelters get repackaged and remarketed with creative titles not unlike the sequel to a bad movie. Within months of the Treasury shutting down LILO transactions, we had something called "Son of LILO," and I wouldn't be surprised if we didn't have "Cousin of LILO" already on the drafting board.

I have been a member of this Committee, of course, only for a few months. And I am not a tax lawyer, and I certainly haven't mastered all of the various revenue rulings, circulars and tax court decisions. But since being contacted by an Austin constituent back in the spring on this problem, what has impressed me most, other than the size of the problem, is the fact that there really seems to be not so much disagreement but rather a consensus that has been voiced by just about all observers that there is a problem, and that the Congress needs to act now, because it affects confidence of both of our corporate and our noncorporate citizens in the tax system.

We are going to hear today from the same people that have expressed in letters to the Committee their growing alarm, their disappointment that we haven't addressed this issue, and the serious challenge that this poses. I believe that the only folks that object to taking prompt legislative action are the tax hustlers, who are earning millions of dollars from these schemes, and perhaps a few of the tax dodgers.

I am not here to glorify H.R. 2255. I believe all of you have copies of it. I doubt that it is the final word on this matter, and I hope that from some of the questions and discussions today it can be perfected further. But what it basically seeks to do is to focus on the economic substance of a transaction, and is based on testimony we received back in March and the Senate received in April.

If I can be indulged for just about another minute to quote you and to do so favorably.

Chairman ARCHER. The gentleman will certainly have adequate time for his presentation.

Mr. DOGGETT. Thank you. I will rush through these and then respond to questions.

But I do want to join with some of the comments that you made in the opening. There is also, other than Section 3, which focuses on the economic substance rule, Section 4, though it involves some drafting work, is not original to me. I tried to copy as closely as I could the recommendations that were made to this Committee back in the spring and to the Senate Finance Committee, regarding the disclosure requirements by the American Bar Association's tax section, which are somewhat similar to the disclosure requirements of the New York State Bar Tax Association.

In Section 4, we also increased and tightened the penalties for tax dodging, an issue that the Joint Tax Committee has also addressed, to deal with the reasonable cause opinion letter excuse which I think has been a loophole to escape penalties. And then also we deal with this question of normal business transactions, and that is where I said I would quote the chairman.

I believe when you opened our hearing back on March the 10th you indicated that this area merited review and that we are going to try to eliminate every abuse that circumvents the legitimate needs of the Tax Code. But you added, as you have this morning, we are not going to cast a net that will snare everyone. And I just want to indicate to you, Mr. Chairman, and to our colleagues, that my objective is to have that same kind of net. I am interested in snaring every hustler and cheat.

I am not interested in impairing legitimate business transactions, in invading ordinary tax planning. And I think that one of

the ways that I do this in the proposal called H.R. 2255 is to have a section there at pages 6 and 7 concerning normal business transactions. That has been reviewed and received some favorable comment from at least one of the officers from the American Bar Association Tax Section.

And I think that, while the purpose of this legislation is to be anti corporate tax dodger, it is not intended to be anti corporation or anti business. Indeed, the idea is to level the playing field. Many of our smaller businesses don't get offered some of these high-priced tax shelter packages.

And, finally, I think the chairman has recognized again this morning, as you did in March, that we ought not to accord the tax enforcers unlimited discretion. And that is why I tried to focus in, instead of defining tax shelter broadly, on the economic substance doctrine which we already have some experience with, at the same time that we strive for more certainty in the law, so that a taxpayer will know what is required of him or her.

It is important that we not merely provide such a strict and narrow change in the law that we are according only a road map for tax cheats. I believe that this Abusive Tax Shelter Shutdown Act, while certainly not a panacea, would provide some help as it is perfected here in the Committee to law enforcement to close some of the loopholes, eliminate sham transactions and stop the hustlers.

That is my objective, Mr. Chairman; and I thank you for providing me with this chance.

Chairman ARCHER. Thank you for your testimony, Mr. Doggett; and, without objection, any entire written statement that you have will be inserted in the record.

[The prepared statement follows:]

Statement of Hon. Lloyd Doggett, a Representative in Congress from the State of Texas

Mr. Chairman, Mr. Rangel and fellow Committee members, I appreciate the opportunity to testify today on corporate tax shelters. In June, I introduced HR 2255, the Abusive Tax Shelter Shutdown Act, along with my colleague Mr. Stark and other Members of the House. This represents the lone proposal targeting abusive shelters filed during this Congress.

As we gather here on what the House Leadership recently indicated would be the last day of this session, I believe that inattention to the rampant spread of abusive corporate tax shelters represents one of the major failures of this Congress. The proliferation of abusive corporate tax shelters is costing the federal treasury billions of dollars.

Professor Michael Graetz recently defined a tax shelter as "a deal done by very smart people that, absent tax considerations, would be very stupid." It is true that many such abusive tax shelters are already illegal. The problem is that every time we shut down one scheme, tax dodgers come up with more. And that is not by accident. One Big Five accounting firm reportedly requires its very smart staffers to come up with at least one of these economically stupid but tax wise corporate tax dodge ideas per week.

The literal 'hustling' of improper tax shelters is so commonplace that one representative of a major Texas-based, multi-national corporation recently indicated that he gets a cold call every day from someone hawking such shelters. Some are even called "black box" proposals, kept under wraps and only offered to a select few clients to avoid public notoriety.

As a partner at one national firm boasted, "A whale can't get harpooned unless it surfaces for air." I would call that a whale-sized gulp of arrogance toward honest taxpayers everywhere who dutifully file returns every April 15 and have to make up for the taxes that some improperly dodged.

Similarly, Stefan Tucker as Chair of the American Bar Association Tax Section, a group comprised of 20,000 tax lawyers across the country, told the Senate Finance Committee on April 27 that:

[T]he concerns being voiced about corporate tax shelters are very real; these concerns are not hollow or misplaced, as some would assert. We deal with corporate and other major taxpayer clients every day who are bombarded, on a regular and continuous basis, with ideas or "products" of questionable merit.

Complicated tax dodging schemes impact ordinary taxpayers in at least two ways. They must both make up for the revenues that tax cheats fail to provide, and they must pay more for enforcement. In one prominent tax shelter case, the cost of a federal victory this summer, after prolonged litigation, was over two million dollars. Amazingly, some actually rely upon such law enforcement successes as justification for opposing reform. Ad hoc remedies achieved through years of litigation have not prevented the steady growth in abusive practices. Indeed, the creativity and speed with which new and more complicated tax shelters are devised is remarkable. Following judicial and administrative rulings, tax shelters are repackaged and remarketed with creative titles like sequels to bad movies. Within months of Treasury shutting down the LILO transactions, products are now being sold as the "Son of LILO." Probably "Cousin of LILO" is already being drafted.

I. The Problem

The dimensions of this problem were first brought to my attention by a constituent in Austin, who urged me, as a new Member of this Committee, to focus some attention on abusive corporate tax shelters. As I have done so, Mr. Chairman, beginning with preparation for a hearing before this Committee on March 10, I have been impressed not by the discord or disagreement but with the near consensus of all observers regarding the troubling extent of the problem, its damaging impact on citizen confidence in our tax system, and the need for this Congress to act legislatively now.

Among those who have recognized the serious need to address these abusive and bogus loopholes are experts from whom we will hear again today:

- With this Congress having ignored their March and April testimony calling for prompt action, on September 9, the American Bar Association Tax Section again wrote to the Chairs of the tax writing Committees expressing a "growing alarm with the aggressive marketing of tax 'products' that have little or no purpose other than the reduction of Federal income taxes."
- With a similar experience and concern, the New York State Bar Association Tax Section on September 14 wrote, "We were disappointed to see that after all this study and testimony and the Administration and Joint Committee reports, the [Republican tax bill] did not contain any provision dealing with this subject. Once again, we express our concern as to the negative and corrosive effect that corporate tax shelters have on our system of taxation and again call for Congressional action on this subject."
- The Joint Committee on Taxation reported on July 22, "The Joint Committee staff is convinced that present law does not sufficiently deter corporations from entering into arrangements with a significant purpose of avoiding or evading Federal income tax...The corporate tax shelter phenomenon poses a serious challenge to the efficacy of the tax system. An obvious concern is the extent of the loss of tax revenues....The proliferation of corporate tax shelters causes taxpayers to question the fairness of the tax system."
- The Treasury Department, in a report released in July said, "The proliferation of corporate tax shelters presents an unacceptable and growing level of tax avoidance behavior."

About the only people who openly object to prompt legislative action are the tax hustlers, who are making millions from the schemes they concoct, and perhaps a few of the tax dodgers themselves.

II. The Legislation

As filed, HR 2255 represents an attempt to stop at least some of the more egregious corporate tax shelters. The findings and purpose clause contained in Section 2 is very important; it seeks to send a clear and unequivocal message not only to the shelter hustlers and tax dodgers, but also to the courts and the Administration that Congress wants this mess cleaned up.

A. Economic Substance Test

Tax shelters hustlers offer their corporate clients complex deals that promise substantial, near risk-free tax avoidance without any significant possibility of actual profit or loss. HR 2255 says look at the substance of the entire deal—was it done to earn a profit or only to achieve a tax rip-off.

HR 2255 codifies the judicially-developed economic substance test, which would disallow transactions where the profit potential is insubstantial compared to the tax benefits. This test, which courts have been applying for many years, prohibits transactions lacking any legitimate business purpose ginned up to obtain a loss, credit, or deduction for the purpose of dodging taxes. As commentator Lee Sheppard wrote in *Tax Notes* recently, this represents "an objective and easily administered test."

> The test is, after all, just the sort of mathematical analysis that the promoters and their customers sit down and do when they reach an understanding about the customer's tax benefits and cash flow. [It] would deny tax benefits when the present value of the reasonably anticipated pretax profits is insignificant relative to the present value of the claimed tax benefits.

As you see, Section 3 at pages 4–5 (§ 7701(m)(3)) creates a rebuttable presumption that a transaction has no economic substance when the tax transaction is not reflected on the books or records (no financial reporting) or when the transaction allocates the income or gain to a tax-indifferent party such as a tax-exempt entity but retains the tax benefit for the taxpayer.

As reflected on page 6 of HR 2255 (§ 7701(m)(5)(B)), complicated, multi-step transactions will be collapsed, and each step must meet the economic substance test. This provision represents a codification of the common law step-transaction doctrine of taxation, and the objective is to preclude shelters that have been hidden in separate but very related transactions that have no economic meaning and that are merely designed to create tax benefits.

On page 7 (§ 7701(m)(5)(E)), certain tax incentive programs, such as the Low Income Housing Tax Credit, which have been defined in statute by Congress, are excluded from application of the economic substance test.

B. Disclosure

Section 4 at pages 10–12 (§ 6662(i)(3)) advises a company that thinks it has a proper shelter to provide complete, clear and concise disclosure. These disclosure provisions closely track the thoughtful commentary of tax practitioners from the American Bar Association Tax Section and are similar to those of the New York State Bar Association Tax Section. Disclosure includes among other things a detailed description of the facts, as verified by a corporate financial officer, including fees paid to promoters and existing warranties. What I seek is for a responsible corporate officer to disclose in clear and concise language the legitimate business purposes of a suspect transaction.

C. Penalties

Section 4 at pages 8–9 (§ 6662(i)) increases and tightens the penalty for tax dodging. The Substantial Underpayment Penalty for transactions held to be lacking economic substance shall be increased from 20% to 40%, with no exceptions for "reasonable cause." However, if a sheltering corporation fully and adequately discloses this shelter, as described in the previous section, then the 20% existing penalty rate shall apply. By increasing the penalties, corporations will be discouraged against setting up the shelters in the first place, rather than taking the limited risk that if caught later, they would owe the same tax and a little interest.

The "reasonable cause" opinion letter excuse has allowed taxpayers to escape all penalties, and has operated as a huge loophole. Taxpayers need only shop around the barest of facts on a shelter in order to get an opinion that their sketchy description is "more likely than not" legal. Getting some downtown lawyer to bless what some tax hustler has cooked up will not save the corporation from penalties anymore if it has clearly stepped over the line with an abusive tax shelter. As Harold Handler, chair of the New York State Bar Association Tax Section, testified on April 27 to the Senate Finance Committee in favor of eliminating the opinion excuse:

> Consequently, corporate taxpayers would be forced to assume a real risk in entering into these transactions, and advisers would be induced to supply balanced and reasoned analysis rather than supplying 'reasonable cause' as under current law.

III. REASONABLE STANDARDS PRESERVING NORMAL BUSINESS TRANSACTIONS

In closing, Mr. Chairman, let me indicate that I share the views expressed by you in opening this Committee's March 10 hearing:

> The area of corporate tax shelters is one that merits review. . . .We are going to try to eliminate every abuse that circumvents the legitimate needs of the tax code. . . .We're not going to cast a net that'll snare every one.

I want to cast my net the same way to snare only every hustler and cheat. I believe that we can curtail abuses without impairing legitimate business transactions, that we can slow the tax hustlers without precluding ordinary tax planning. One of the ways HR 2255 seeks to further this objective is by the inclusion of a rule at pages 6–7 (§7701(m)(5)(C)) entitled "Normal Business Transactions," which provides:

> In the case of a transaction which is an integral part of a taxpayer's trade or business and which is entered into in the normal course of such trade or business, the determination of the potential income from such transaction shall be made by taking into account its relationship to the overall trade or business of the taxpayer.

Ronald Pearlman, the vice chair for government relations at the American Bar Association Tax Section has praised this provision of HR 2255 as it "takes the pressure off" legitimate business transactions. This legislation is not directed to normal business but to the abnormal activity that concerned the Tax Section in the testimony to this Committee on March 10:

> The aggressive tax shelters that concern us do not overuse tax benefits consciously granted by Congress (such as accelerated depreciation or credits) nor are they tax-favored methods of accomplishing a business acquisition or financing. They are transactions that the parties themselves would generally concede have little support in sound tax or economic policy, but are, the parties assert, transactions not clearly prohibited by existing law.

While this legislation is anti-corporate tax dodger, it is certainly not anti-corporation. Indeed, it should be characterized as pro-business, and particularly pro-small business. This bill levels the playing field for small businesses, which are not offered the dodges available to some of their large competitors.

Additionally, I share the view that tax collectors should not be accorded unlimited discretion. That is one reason why I chose to rely on the well-established economic substance doctrine. Similarly, the law should be clear enough to inform taxpayers and their advisors of what is necessary to assure compliance. What must be avoided, however, is a law that avoids reasonable standards in favor of a narrow list of prohibitions. Rather than stopping abuses, this approach would only provide a roadmap for tax cheats. As the testimony on behalf of the American Bar Association Tax Section before this Committee on March 10 indicated:

> [T]otal certainty is impossible where complex transactions are involved. This is particularly true when the parties seek to avoid judicial principles developed to deny tax benefits to overly tax-motivated transactions. Taxpayers and their advisors know that relative certainty can easily be achieved in legitimate business transactions by steering a safer course and staying in the middle of the road. The more clearly the transaction stays within established judicial and administrative principles, the more certainty is assured. When they venture to the outer edge, certainty cannot be assured, nor should it be; the parties who consciously risk going over the edge should clearly understand there are severe consequences for doing so.

Today there are many inequities and injustices associated with the federal tax code. Some of the worst arise from those who use abusive tax shelters to exploit tax loopholes. The Abusive Tax Shelter Shutdown Act is not the final answer; it is certainly not a panacea, but it will help law enforcement to close some loopholes, eliminate sham transactions, and stop these hustlers. As we might say in Texas, "shut 'em down, and move 'em out."

Chairman ARCHER. Again, the Chair's desire from the beginning of taking the chairmanship of this Committee is to be sure that we eliminate unjustified abuses in the Tax Code. But so often it is difficult to separate the wheat from the chaff.

And it is not just the complexity of the Tax Code that has concerned me over the years, it is the administrative cost and red tape

to taxpayers in the private sector, which has been estimated to be anywhere from $250 billion a year to $600 billion a year, depending on whose estimates you want to take.

So the concern I think should be what we are putting on our entire economic system from the standpoint of administrative burdens. We need to work our way through that and try to find a way to separate the wheat from the chaff.

The Joint Committee on Taxation, as you know, has issued a report on penalties and interests. And they stated in their analysis of your proposal that the way it is currently drafted could affect not only tax shelters but legitimate business transactions. And you have appropriately stated that you don't want to affect legitimate business transactions, so we have got to find a way to work through that.

As I said, your currently drafted proposal, you deny every deduction, loss or credit under the tax law, unless the taxpayer can prove that it meets the test contained in the bill, the tests of which are not completely specific, but are, to some degree, vague.

How can a taxpayer show that the present value of reasonably expected potential income from the transaction and the taxpayer's risk of loss from the transaction are substantial in relation to the tax benefits claimed? Are we back into the mode of putting a burden on the taxpayer to prove innocence which we attempted to reform in the IRS reform efforts of the Committee? How is a taxpayer going to be expected to satisfy that burden?

Mr. DOGGETT. Thank you, Mr. Chairman.

First, with reference to your comment about the Joint Tax Committee comment, I think that that particular reference which has been cited by a lobby group in a letter to the Committee was not to my proposal. They may feel that way, but what they were writing about was a proposal that the Treasury discussed back at the time of our March hearing, which I also had some problems with, and that is why I tried to narrow in on the economic substance doctrine.

But even when you narrow in on the economic substance doctrine, as your question suggests, there is a question of how much certainty is it appropriate to accord in order to separate, which can be challenging, the wheat from the chaff.

I have used the term ''substantial'' at one point on page 4, ''meaningful'' at another point on page 4. The way the Joint Tax Committee, in its penalty recommendation that you referred to, it uses similar terms that are not 100 percent specific. It uses the terms ''significant'' and ''insignificant'' in its analysis, I believe that is over on about page 234 of the Joint Tax Committee recommendation from the staff back in July.

But let me indicate why I think there has to be some flexibility in those terms. And, again, they are terms that I didn't dream up by myself. They came right out of the testimony that this Committee got in March from the tax law experts and that the Senate heard, too.

If you have a taxpayer who has purchased a shelter from one of these tax hustlers and perhaps has paid several million dollars for it and they paid several hundred thousand dollars to a tax lawyer for an opinion, they are not going to come into law enforcement and

say, I did this deal to cheat on my taxes and tough luck for you. They are paying for all that high-priced advice to dress up the transaction in a way to make it appear to be something that it is not; to make it appear that they took on some real risk, and that this was a legitimate business transaction.

And so there is a need I think in Section 3, in looking at this, to suggest that if there was only a very modest, insubstantial change in the taxpayer's position, that that will not suffice.

And I believe in saying that, as far as the burden on the taxpayer, it is not my desire to increase the burden on the taxpayer over what I believe the existing better law is of the tax decisions. I think that is what the current doctrine of economic substance already requires. I believe it is appropriate to demonstrate that the change in the real economic position of the taxpayer is not dwarfed by these claimed tax benefits; that it is not a thousand dollars of potential benefit with a million dollars of tax loss.

Chairman ARCHER. Would it not be appropriate, if the Committee chose to implement this type of proposal, to provide that the IRS has to prove that the tests contained in this bill are not met in order to deny a deduction, rather than to say that every deduction, loss or credit under the tax law is denied unless the taxpayer proves? Would it not be more appropriate to put the proof on the IRS in the same sort of context that our IRS reform proposal did to address the concerns of taxpayers all over this country that they are put in a position of having to prove their innocence rather than to be put in a position of the IRS proving guilt?

Mr. DOGGETT. Of course, I supported your provision to do just that with reference to our Taxpayer Bill of Rights. And I think that reference to this kind of tax hustling, I would want to hear from the Treasury Department on their feeling about how that burden of proof is placed.

Chairman ARCHER. Okay. Just one last follow-up question. Then we will recognize other members of the Committee.

Mr. DOGGETT. Sure.

Chairman ARCHER. Does your bill define the term substantial? What is the definition of substantial? What is the definition of reasonably expected potential income? And what is the definition of risk of loss?

Mr. DOGGETT. It is more than de minimis, more than nominal, more than just enough to pay the bill of the tax hustler that got you into the tax shelter in the first place. But there is no attempt to define this really in any way other than the true dictionary definition of these terms.

Does it have meaning? Is it real? Or is it some circular sham like some of these town hall leasing arrangements that have been disapproved? And it does allow for some discretion, just like the recommendations of the Joint Tax Committee, using terms like significant and insignificant, allows for some discretion. And I don't know any other way to do it without writing a road map that is so narrow that it allows hustlers to immediately write around it.

Chairman ARCHER. There would be a concern on the part of the chairman as to giving the IRS greater gray areas to pursue, which has been one of the real complaints in the Tax Code today, where the discretion is in the eye of the beholder and the IRS's discretion

will put significant additional litigation into play. And I just think we need to work through that.

Mr. Rangel.

Mr. RANGEL. Let me agree with you, Mr. Chairman.

I think that we are finding many different groups that recognize your leadership in this area, the American Bar Association, the Treasury Department, the IRS, and the Joint Committee on Taxation. No one wants to be retroactive. No one wants to disrupt legitimate business transactions.

Have you discussed your bill with Treasury and asked their advice as to how we best proceed without causing additional problems to the IRS?

Mr. DOGGETT. I have discussed it with Treasury. And I believe, following the hearing that we had where this Committee had the first discussion of this particular bill, H.R. 2255, when you incorporated it, Mr. Rangel, into the democratic substitute on the extender's bill, there was some discussion in the Committee about why the Committee had not acted. We heard from Ms. Paull about the interest and penalties report. And so I sought to inquire of them about the bill, how it would work, and whether there was any reason for the course not to proceed to adopt a measure of this sort.

I think they will speak for themselves today, but that they basically embrace the approach taken by this bill. I am sure, just like members of the Committee who support the bill or have questions about the bill, it is not without perhaps the need to do some perfecting here and there. But the basic approach I have taken I believe has been embraced by the Treasury Department.

Mr. RANGEL. I think that is a good beginning.

You have pointed out areas of concern about tax shelters. The IRS has an opportunity to agree or disagree with you. Where they do agree, I think the IRS has a responsibility to share with this Committee how we can best carve this cancer out of the Tax Code. Then, with the help of the Joint Committee on Taxation, I think we can move forward.

I just don't know in terms of the timetable of this Committee when reform will happen because, Mr. Chairman, I would agree with you that this should occur when we are pulling up the Code by the roots. And I have been trying to get on the buses to go around to see how you intended to do this, but so far there doesn't seem to be a majority plan to do this. If you are waiting for me to come up with a plan——

Chairman ARCHER. If the gentleman would yield. I would be happy to receive your contender in this arena, because I know you are interested in tearing the income tax out by its roots. You talk about it all the time. And I would be pleased to know what concept you support to do that, because I have made my support of the conceptual way to do that, very, very clear, so I hope we can work together on that.

Mr. RANGEL. I hope so, Mr. Chairman. We can start with hearings, I would think, and then we can see which concept best suits this Committee.

Mr. DOGGETT. Mr. Chairman, if I may just respond to part of Mr. Rangel's comments that I would view as a query. If you turn even to today's Wall Street Journal, on the front page there is an indica-

tion that one of our later witnesses, Mr. Sax, representing the American Bar Association Tax Section, has said that shelters are increasing, are attracting big, not only multinational companies but also midsized businesses and wealthy individuals.

It was only a few weeks ago that another member—another prominent tax lawyer in the same column, Mr. Michael Schler with Cravath, Swaine & Moore said there is not going to be much left of the corporate income tax the way things are going. He said the capital gains tax for corporations is essentially elective these days, because of the growing proliferation of tax-saving techniques.

My concern, there may be a day when we will all be gardeners and rip out the income tax system by its roots and substitute the more sales tax approach that I have heard you comment on, that I have heard some other people in Texas comment on. But, until we do, I just believe that every business entity and taxpayer, be they big with access to these tax hustlers or be they a midsize company that doesn't have that access yet—but, as Mr. Rangel says, it is a cancer corrupting the system, and they may well in the future—that they all play on a level playing field and we enforce the law equitably.

And I believe that is not too far from the objective that the chairman expressed, though we may have a little bit different means of getting there.

Chairman ARCHER. Does any other member? Mr. Hulshof.

Mr. HULSHOF. Thanks, Mr. Chairman.

Welcome, Mr. Doggett. It is interesting to have you on the other side.

I note from your written statement and your oral testimony you used the terms hustlers, arrogance, tax cheats and tax-dodging schemes, and I want to thank the gentleman for toning done his rhetoric today. And, in seriousness and candor, do you have a fundamental belief, Mr. Doggett, that businessmen and women have a desire to cheat on their taxes?

Mr. DOGGETT. No, I don't think so. The term tax hustler is also not original to me. It came from, as you know, from hearing some of my comments on it, a cover story in Forbes Magazine, known as The Capitalist Tool, not some ultraliberal publication.

But I do think, and I believe your question really goes to the heart of it, and Mr. Rangel's use of the term cancer. If you know your competitor is taking advantage of one of these outlandish tax shelter packages and they are getting away with it, then even the most honest, good-faith operating business and tax department is encouraged to do the same thing. And I think it drives the whole standard down, and I think it has the same effect on the tax attorneys themselves, and that is one of the reasons they have been coming to the Committee saying, please move quicker, because we can see what this is doing to our profession and to our clients.

Mr. HULSHOF. Were you present, and I forget the date, earlier this year when we had various representatives—and the one that specifically comes to my mind was a representative of Daimler Chrysler. And I remember—Mrs. Johnson is not here today, but I remember the questioning, the line of questioning that she had. And I don't want to put words or mischaracterize the testimony of the representative from Daimler Chrysler, but I heard that rep-

resentative intimate that the reason that the corporate headquarters moved from the United States to another country was because of the complexity of the Tax Code.

Now, do you believe that were your bill, H.R. 2255, were to be enacted, do you think that that would be more business friendly or less business friendly?

Mr. DOGGETT. I was here for that testimony, and I think it would be more business friendly.

And let me say again, your question really cuts to the core of this problem. Because while the Daimler Chrysler people were talking about where this business was located, one of the worst aspects of these shelters is using offshore entities, of running the loss to the company that is based in America and hiding the gain in some offshore entity that can never be taxed.

And that is the kind of transaction, this focusing offshore dodging taxes in an improper way, that I think the terms like tax hustler are exactly the right terms.

Mr. HULSHOF. Treasury we will hear from a little later, but I know in an earlier paper, a White Paper issued regarding—just on corporate tax shelters, that a major source of discrepancy between book income and tax income is depreciation that is claimed on taxpayer investments. Do you intend to deny or reduce depreciation deductions that are provided under tax law and capital equipment purchased by our Nation's business, and does your bill have guidance regarding depreciation and expensing?

Mr. DOGGETT. I believe that the bill does have adequate guidance to deal with this problem in the normal business transaction section. It is not my desire to interfere with depreciation, but let me point to one exception in that regard, an even clearer normal business transaction is rent. I certainly don't intend to interfere with rent or a purchase of property.

But if the rental, as was the case with the Swiss town hall, the business is not in the business of renting properties in Switzerland, and it goes out and it rents a Swiss town hall that it never has a meeting in, never intends to use for rental and immediately turns around and rents it back to the Swiss, it can claim its rental payments as a loss and defers the income. If it is doing a nonsubstantive kind of transaction, then, yes, it does have to meet the economic substance test.

It is conceivable that some depreciation scheme that was not substantive, that was truly circular, might require that analysis. But it is not my intent to interfere with depreciation.

Mr. HULSHOF. As the gentleman knows, my time is about to expire, and I think this is a fairly simple yes or no answer to the chairman's previous point. As your bill is drafted, isn't it a fact that every deduction loss or credit is denied unless the taxpayer or in this case the corporate entity proves or meets the test that you put in the bill? Isn't that the essence of your bill, that everyone is denied unless they can prove that it is a legitimate expense?

Mr. DOGGETT. So long as it has economic substance. So long as it is a real deal. That is all they have to show. If it gets off the line—to go back to the testimony of the American Bar Association to this Committee, if it gets way off the line, then they have to demonstrate economic substance. And my suggestion to the chair-

man earlier was that we inquire further of Treasury concerning the way that the burden of proof would work on this issue.

Mr. HULSHOF. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. The gentleman's time is expired.

Mr. Foley.

Mr. FOLEY. Thank you very much, Mr. Chairman.

A lot of us point fingers and call things abuses; and, obviously, I think we have to probably look in the mirror. As Members of Congress, we write the Tax Code. And we have done so, whether it is been brilliantly or poorly, we have to take a lot of the burden ourselves.

I look back at the 1980s and think about some of the unique things that were offered citizens as investments, oil and gas partnerships, real estate investments, where you would have excessive depreciation, but it was provided for under the Code. And you would sell this based on the return, not necessarily on a cash-flow basis, but you would use the depreciation as a way to shelter other ordinary income, but that was provided for by the Congress. Was that abusive and should that have been ruled abusive?

Mr. DOGGETT. I think the Congress looked at that and made some changes in the tax laws to deal with those problems.

My focus here has been on corporate shelters. But as I mentioned in the Wall Street Journal story from today and other testimony we are hearing about, these are beginning to spread into other areas.

I am not sure that this bill as drafted would adequately deal with some of the problems with individual tax shelters. My focus has just been on where the problem started, but I think if we don't stop it where it started, it will spread and get back to some of the abuses that this Committee long before you and I got on it decided were sufficient problems to outlaw.

Mr. FOLEY. How does your by bill, though, treat a legitimate transaction? I understand there is an enactment date, but what happens in the event that somebody invested in a shelter such as a real estate limited partnership? They find at the end, because of a change in the Tax Code which occurred in 1986, which basically put the real estate market on the skids, which the change of the Tax Code then resulted in the FDIC having to bail out numerous S&Ls and banks because of the throwback of properties that no longer have value because they unwound the depreciation—now, obviously, there was a time when they invested based on the economic return or, more importantly, based on the tax aspects. We unraveled that in 1986—or those who were here. Would this bill then look at that as the new enactment date and claim that abuse and then file this bill accordingly?

Mr. DOGGETT. This bill is written to be prospective in effect and not to reach back. But I think some of those transactions under the judge made law that I try to codify here in the economic substance test may already be suspect, and those people may have a problem if they get picked for an audit.

But this particular bill, H.R. 2255, would be prospective in nature and not retroactive.

Mr. FOLEY. That is a concern. And I know a lot of taxpayers who invested assuming they were going to make their retirement a little bit rosier based on projections by speculators, and ultimately not only did they lose their capital but they—the IRS came in calling for excess depreciation recapture. And so they had—the IRS was due for their recapture, and so they found themselves not only out of cash from their original investment, but now they found themselves further owing the IRS monies, because they accelerated depreciation.

I think there are problems in the Tax Code, but my bigger concern is are we, in fact, not or shouldn't we be speaking to ourselves and not the corporate community? If, in fact, the tax law allows some of these loopholes or, in fact, creates creative accounting gimmicks, then it is our job, not necessarily simply by enacting a law, to say corporations are ripping off the taxpayers. It may be given the guidance by the U.S. Congress to do so.

Mr. DOGGETT. I think it is our job, and I agree with you fully on that.

I think that is the irony of the situation we find ourselves in this year. I believe that sometime in the past, before you and I joined the Committee, the Committee had been very critical of some aspect of the tax-paying community or particularly of the tax advisers, the bar. Here is a situation where the people who represent 20,000 tax lawyers across the country that have to deal with all the problems you just mentioned are coming, telling the Committee that they are alarmed because we haven't dealt with this problem yet.

And so I think it is strange, that it is a time when those who are out there having to deal with these problems day in and day out are saying to us, as members of this Committee, please come in and change the law to help us in upholding the standards of our profession and providing competent tax planning advice to clients that want to comply with the law, rather than corrupting the system with the cancer that is beginning to spread and will eventually affect individuals.

The kind of tax shelters that we have today that I say are being hustled, that made the cover of Forbes, cost more, I believe, than most wealthy taxpayers are paying in their total tax bill.

Mr. FOLEY. Would you support a flat tax or a sales tax in order to end the ambiguity?

Mr. DOGGETT. I am not prepared to do it today. But I will tell you that I haven't totally ruled out in my own mind some of the ideas that have been advanced by the chairman and others to change the system. Because even from the few months I have been on the Committee I can see what some of the pressures are and how these tax bills are written.

So I am not prejudging the final answer, if we are down to looking at alternatives to pulling the system out by its roots. Today, I would be inclined to stick with trying to perfect the system that this most powerful nation in the world has relied upon for the last many decades.

But I won't rule out considering alternatives in the future. I am just saying, in the meantime, let us be sure that everybody is play-

ing by the rules and paying their fair share of taxes so we don't shift the burden to the few who can't afford a tax hustler.

Chairman ARCHER. The gentleman's time has expired.

There is a vote on the floor, and the Chair will recess the Committee for us to vote.

When we come back, Mr. Jefferson will be recognized to inquire.

[Recess.]

Mr. MCCRERY. [presiding.] The Committee will come to order.

Mr. Doggett, we appreciate your sticking around for a few more questions; and I believe the chairman had said that Mr. Jefferson was next to inquire. Mr. Jefferson.

Mr. JEFFERSON. Thank you, Mr. Chairman.

Mr. Doggett, I want to ask a question about the whole purpose of this discussion we are having here today. Most reports say that corporate profits are increasing, yet our corporate taxes are apparently lower than they should be, given the rise in corporate profits.

We use the Tax Code for a lot of different things which are collateral to its real purpose. We use it to incentivize various activities, to rebuild communities and for housing construction and all sorts of things and research and development, which I will follow up with you on in a minute. But, ultimately, isn't the real purpose of the Tax Code to collect taxes from the regular economic activity of the public?

And I want to ask you, in regard to that, whether you think the lower corporate taxes that are being collected can be attributed in any way to the proliferation of tax shelters and, if so, to what extent? And how much are we actually experiencing is losses in the government treasury as a result of these schemes you talked about today?

Mr. DOGGETT. Well, as I told the Committee earlier, I don't hold myself out as a tax expert. All I can really do is look at what those who are experts have been saying. I have used in some of my presentations on this the $10 billion per year figure that Professor Joseph Bankman of Stanford Law School has used. I couldn't find the precise basis for that. I expect it is an estimate. I have had other people who are experienced in this field tell me he is off by one zero, and it is larger than that.

We will hear testimony later today looking at the way corporate profits have increased and corporate tax receipts have not kept pace, suggesting that the shortfall might be $13 to $24 billion a year, though there may be some other factors at play. Those who know the most about how much money is being avoided improperly here keep it to themselves. Obviously, they keep it secret.

I do think, and this may or may not be responsive to your question, but I am trying to be, that to those who say, well, as I saw one set of lobby groups did, you are proposing a $10 billion tax increase. It is not my objective to increase taxes. It is to see that all those who are paying a current level of taxes pay their fair share on the same even playing field.

And it seemed to me that, responding to the tax increase argument, not me and not a Democrat but our Republican colleague Charlie Norwood got it right on this issue about a tax increase when, in defending this same proposal, H.R. 2255, before the House Rules Committee here a couple of months ago, he said, and I quote,

"There is a large difference in what you call a tax increase and stopping bogus tax shelters. That is really two different things. They aren't just asking them to pay more taxes. We are trying to keep them from cheating the system.".

And that is my objective, to stop the cheats, whether the figure is $1 billion, which is what my bill has been scored on in raising over a year, or whether it is $10 billion or $100 billion or somewhere in between.

Mr. JEFFERSON. When taxpayers send us here and say take care of waste, fraud and abuse, and that is an answer to some of the revenue issues we have here, as far as you see it, they are really right. And this is an area we can attack some of these problems by pursuing the course that you are talking about today.

Let me ask you something else, and Mr. McCrery may have a more detailed question about it as we discuss in what area where you have some difficulty in framing exactly what is a shelter and what is not. And is any research and development area, which I mentioned to you as we were walking out—that is an area where we are doing a lot in the Tax Code. We are trying to get it to have—because of the latest technology and thus the strength of our economy, to give companies opportunities to engage in further research and development, many of which enterprises result in virtually nothing of economic value, and they involve large expenditures that we permit them to write up. How does your bill deal with that sort of an issue?

Mr. DOGGETT. This does relate to a question that I think Mr. McCrery has focusing more on the oil industry. The research and development tax credit, as you have heard me say in this Committee, is very important in central Texas to our technology companies, as it is to many other parts of the American economy.

It is never mentioned in this bill. And it is not mentioned because I don't believe that it is one of the economic return enhancements where this Congress has specifically said, and you mentioned, the low-income housing credit. We said, with low-income housing tax credits, we think this is so important that, while it may be viewed as not having economic substance for the companies and individuals that take advantage of the low-income housing tax credit, that we are providing a special economic return enhancement, as I defined it on page 7 of the bill, to encourage that.

And I have attempted to identify those. I may not have every one that there is. That was my objective,and I provided a catch-all to pick it up, so that Treasury could pick any up that I had omitted that were properly done through regulations.

But the research and development tax credit is part of normal business operations like rent, like paying executives, like other investments. It has economic substance. The business engages in it to earn more profits. It is not a circular kind of an arrangement that is done just to dodge taxes.

Mr. MCCRERY. Mr. Doggett, I do have a question about the oil industry. Before I get to that, though, I want to say that you are to be commended for looking into this area. I don't think any of us want corporate entities or individuals to be abusing provisions of the Tax Code to shelter income that we don't intend to be sheltered. And I also appreciate your willingness, as stated earlier, to

work with us in Treasury and Joint Tax and perhaps members of the private sector to more carefully craft some of the provisions in your legislation to make sure that we don't paint with too broad a brush here.

And one of the broad brush strokes that I see in your bill that gives me some concern are lack of definitions in the terms. For example, one of the tests that a taxpayer has to pass to claim as tax benefit is the present value of the reasonably expected potential income from the transaction, and then it goes on. And the example I gave you as we were walking over to the House was the independent oil guy that has a wildcatter and goes out and drills a well, knowing full well that there is a 90 percent chance that he won't get any profit from that endeavor. So what is the reasonably expected profit that he would have to meet under that test?

It just seems to me that it causes some potential problems as we try to define those terms. Have you thought about that?

Mr. DOGGETT. Yes. And with reference to the wildcatter, of course, in your part of the country and in mine, without someone willing to take that substantial risk, we wouldn't have much of the energy resources that have fueled our country, and it is important to preserve the incentives for doing that.

I feel that in most instances the wildcatter is never going to get to this test, because we have a section of the bill called normal business transactions. The wildcatter is in the business of searching for oil. This is his normal business transaction, to engage in high-risk propositions. It might be a little different if some company that had nothing to do with wildcatting took all the loss and gave a nontaxable entity all the gain. That is my first answer.

The second one is to focus your attention—and this was a little of my response about the research and development tax credit which is so important to me that Mr. Jefferson asked about. You will see that on page 7 of the bill, at (e), treatment of economic return enhancements, that the very first one—it may or may not be obvious, but the very first one deals with what I understand is called the tight sand credit, where Congress has set up a special standard. Some might say that the tight sand credit wouldn't justify the tests that I have in here.

But I identified that as one that shall be treated as an economic return, a real return and not a tax benefit. And if there are others that affect the oil and gas industry like that and we are concerned Treasury might not recognize them, we should itemize them in the bill.

Mr. MCCRERY. Well, I appreciate that. I think that is one thing that we would want to do in any legislation of this type, is try to identify specific transactions that we know might not meet a rather vague test and say this is one—this is an example of a transaction that we think is justified and should be honored under the Tax Code.

So I think we need to thoroughly examine the Tax Code for other examples like the tight sands credit to make sure those are not thrown out with these kinds of reforms.

Mr. DOGGETT. I appreciate your comments. It gets us back to the discussion that the chairman raised initially in this hearing, is we want enough certainty for a good-faith wildcatter or small business

person or Fortune 500 corporation to know what it takes to comply with the law.

If, however, we define such a narrow list of prohibitions and we give no discretion to the courts under the economic substance doctrine, we are going to find the same tax hustlers that have written around prior work that this Committee under Chairman Archer has done to deal with tax shelters and keep coming up with new ones, like sequels to the bad movies. They will just be given a road map as to how to write around the law. And I think we have to try to define that balance between the desire for certainty and enough flexibility to really prohibit these tax hustlers from doing what they have been doing. Thank you very much.

Mr. MCCRERY. I am glad to hear you say you are willing to try and find that balance and not go too far either way.

Any other member of the Committee wishing to inquire?

If not, thank you very much, Mr. Doggett.

Mr. DOGGETT. I thank you very much.

Mr. MCCRERY. Our next panel is Mr. Talisman from the Department of Treasury and Ms. Paull from the Joint Committee on Taxation.

Mr. Talisman, you are listed first, so I am going to call on you to begin. Please know that your written testimony will be entered into the record in full.

Mr. TALISMAN. Thank you very much.

Mr. MCCRERY. You may proceed.

STATEMENT OF JONATHAN TALISMAN, ACTING ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. TALISMAN. Mr. Chairman and members of the Committee, it is a pleasure to speak with you today about the problem of corporate tax shelters and the administration's proposals to address this important problem.

Mr. Chairman, in 1986 the Congress cured with almost instant results the corrosive effect of tax shelter activities that were eating away the individual income tax base, swamping the IRS and the Tax Code with controversies and causing a cynical attitude toward the tax law among many Americans. Today we are addressing a similar problem affecting the integrity of the tax system, the proliferation of corporate tax shelters, that merits immediate attention.

When we started working on our White Paper late last year, our first goal was to raise awareness there was a problem and to explore the nature of the problem. Now it is clear that there is widespread agreement and concern among tax professionals that the corporate tax shelter problem is large and growing.

For example, in a prior appearance before this Committee, the American Bar Association noted its growing alarm at the aggressive views by large corporate taxpayers of tax products that have little or no purpose other than the reduction of Federal income taxes and its concern about the blatant, yet secretive, marketing of such products.

The staff of the Joint Committee, the New York State Bar, TEI and others have echoed their concern over the proliferation of shel-

ters. Thus, we have moved from whether there is a problem to what to do to solve the problem. With your help, we hope to curtail the development, marketing and purchase of corporate tax shelters frequently sold as products off the rack to produce a substantial reduction in a corporation tax's liabilities.

Why are we concerned? First, corporate tax shelters erode the corporate tax base. As Chairman Archer noted in his press release for this hearing, Congress has passed several provisions in the past few years alone to prevent specific tax shelter abuses which collectively would have cost the tax system over $50 billion.

Second, as the New York State Bar Association recently noted, the corrosive effect of tax shelters breeds disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm and to follow the lead of other taxpayers who have engaged in tax advantaged transactions. This race to the bottom, if unabated, will have long-term consequences to voluntary compliance, far more important than the short-term revenue loss we are currently experiencing.

Finally, significant resources both in the private sector and the government are currently being wasted on this uneconomic activity. To date, most of the attacks on corporate tax shelters have been targeted at specific transactions and have incurred on an ad hoc, after-the-fact basis through legislative proposals, administrative guidance and litigation.

For example, recently the Congress passed two provisions to prevent the abuse for tax purposes of corporate-owned life insurance, which were scored in the tens of billions of dollars, the elimination of the ability to avoid corporate level tax through the use of liquidating REITs, which passed late last year, and that provision was estimated by itself to have saved the tax system upwards of $30 billion over 10 years, and legislation passed this year aimed at section 357 basis creation abuses.

Mr. Chairman, we very much appreciate these efforts and that members of this Committee have promptly addressed specific corporate tax shelters that we or others have brought to your attention. At the same time, the Treasury and the IRS have taken a number of administrative actions to address corporate tax shelters.

On the regulatory front, we have issued guidance on stepdown preferred stock, lease trips and foreign tax credit abuses. Most recently, we have brought to light lease-in, lease-out tractions or so-called LILO schemes.

These transactions, through circular property and cash flows, purportedly offered participants millions in tax benefits with no real economic risk. The notion of a U.S. multinational leasing of a town hall from a Swiss municipality and then immediately leasing it back to the municipality is surely out on its face.

Finally, we have recently won several important cases, ACM, ASA, Compaq, Winn-Dixie and others, after many years of litigation. What you find over time, however, is that addressing the tax shelter's transaction by transaction is like attempting to slay the mythological Hydra. You kill off one over here, and two or three more appear over there. Already this year we have shut down so-called chutzpah trusts, which were similar to a structure shut

down by Congress in 1997, and we are now hearing about "Son of LILO" and derivations on the section 357 seed product.

Promoters like computer hackers will continue to search for defects in the Code to exploit, and taxpayers with an appetite for tax shelters will simply move from those transactions that are specifically prohibited by the new legislation to other transactions, the treatment of which has not been definitively prescribed.

Legislating on a piecemeal basis further complicates the Code.

Finally, using a transaction legislative approach to corporate tax shelters may embolden promoters and participants to rush shelter products to market on the belief that reactive legislation will be applied perspectively.

What we have done at Treasury is identify the common sources and characteristics of shelters and incorporated these identified shelters into our budget proposals so that we may address these abusive tax-engineered transactions in a more global manner, hopefully preventing most from occurring. We must change the tax shelter cost-benefit analysis in a manner that is sufficient to deter these artificial transactions.

The Treasury Department believes this global solution should include four parts—first, increasing disclosure of corporate tax shelter activities; two, increasing and modifying the penalty relating to the substantial understatement of income tax; third, codifying the economic substance doctrine; and, fourth, providing consequences to all the parties to the transaction, for example, promoters, advisers and tax-indifferent, accommodating parties.

These proposals are intended to change the dynamics on both the supply and demand side of this market, making it a less attractive one for all participants. All the participants to a structured transaction should have an incentive to assure that the transaction comports with the established principles.

I would like to emphasize a few key points. First, there is widespread agreement that increased disclosure and changes to the penalty regime are necessary to uncover transactions and change the cost-benefit analysis of entering into corporate tax shelters. However, we do not believe that these procedural remedies alone are enough. We believe the economic substance doctrine must be codified, thus requiring taxpayers to perform a careful analysis of the tax effect of a potential transaction before they enter into it.

Let me be clear, the centerpiece of the substantive law proposal is not a new standard but rather is intended as a coherent articulation of the economic substance doctrine first found in seminal case law such as Gregory v. Helvering and most recently utilized in ACM, Compaq, IES and Winn-Dixie.

The economic substance doctrine requires a comparison of the expected pretax profits and expected tax benefits. Codification of the doctrine would create a consistent standard so that taxpayers may not pick and choose between conflicting decisions to support their position.

Second, there are substantial similarities between the Treasury Department's proposals and other proposals to curb corporate tax shelters. For example, the staff of the Joint Committee on Taxation agrees that there should be increased disclosure by participants, in-

creased penalties on understatements attributable to undisclosed transactions and tightening of the reasonable cause exception.

Finally, H.R. 2255, as introduced by Mr. Doggett, contains an approach similar to the administration's proposal, including the codification of the economic substance doctrine. I would like to thank Mr. Doggett for his leadership in this area and the others who have contributed to this important debate.

Finally, the proposed legislation would be inadequate without effective enforcement. The Internal Revenue Service is undergoing a substantial restructuring. This restructuring will concentrate IRS resources relating to corporate tax shelters, enabling it to identify, focus on and coordinate its efforts against corporate tax shelters in a more efficient manner while instituting and maintaining appropriate taxpayer safeguards.

The enactment of corporate tax shelter legislation, combined with this effort, will deter abusive transactions before they incur and uncover and stop those transactions to the extent they continue to occur. We are working closely with Commissioner Rossetti to develop the best overall approach to address corporate tax shelters and the restructured IRS.

Let me assure you, however, that the Treasury Department does not intend to affect legitimate business transactions and looks forward to working with the tax writing Committees in refining the corporate tax shelter proposals. Our White Paper already made substantial revisions to our original broad budget proposals in response to comments we received.

Further, to prevent interference with legitimate business transactions, the IRS and we are considering whether to require examining agents to refer corporate tax shelter issues to a centralized office for consideration. Such a referral process might be similar to that used with respect to the partnership antiabuse rules.

The IRS also is considering whether to establish a procedure whereby a taxpayer could obtain an expedited ruling from the IRS as to whether a contemplated transaction constitutes a corporate tax shelter.

Mr. Chairman, the proliferation of corporate tax shelters presents an unacceptable and growing level of tax avoidance by wasting economic resources, reducing tax receipts and threatening the integrity of the tax systems. This morning we have laid out before you the rationale for a suggested approach for combatting this important problem and discussed why we believe that existing law does not provide sufficient tools to combat this behavior. I look forward to working with you and the members of the Committee to address this problem as we have in the past to curb specific abuses.

Thank you very much.

Mr. MCCRERY. Thank you, Mr. Talisman.

[The prepared statement follows:]

Statement of Jonathan Talisman, Acting Assistant Secretary for Tax Policy, U.S. Department of the Treasury

Mr. Chairman, Mr. Rangel, and distinguished Members of the Committee:

Thank you for giving me the opportunity to discuss the problem of corporate tax shelters with you today. The Committee on Ways and Means has reacted quickly with legislation as specific corporate tax shelters come to light. As you mentioned, Mr. Chairman, the Committee in recent years has acted to close down about $50 billion in tax shelters. Unfortunately, based on all the indications we see, there is

an increasing number of avoidance transactions being undertaken, despite your willingness to enact legislation to stop particular schemes as they are uncovered. Consequently, we are here before you today in support of legislation to deter corporate tax shelter activity on a more comprehensive, before-the-fact basis.

The Treasury Department, in addition to many others, including the American Bar Association, the New York State Bar Association and the staff of the Joint Committee on Taxation, has expressed concerns about the proliferation of corporate tax shelters. These concerns range from the short-term revenue loss to the tax system, to the potentially more troubling long-term effects on our voluntary income tax system. In its FY 2000 Budget, released in February of this year, the Administration made several proposals to inhibit the growth of corporate tax shelters.

In July of this year, the Treasury Department issued its White Paper, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*. This report discussed more fully the reasoning underlying the Budget proposals relating to corporate tax shelters, provided a description and analysis of the comments on the Budget proposals, and provided refinements to those proposals.

Since the issuance of our White Paper, there have been some important developments regarding corporate tax shelters, including the issuance of the staff of the Joint Committee on Taxation's study of present-law penalty and interest provisions, as well as some important court decisions. With these developments in mind, I would like to emphasize the following points in my testimony today.

First, corporate tax shelters continue to be a substantial and ongoing problem. While Congress, the Treasury Department and the Internal Revenue Service take action to stop particular transactions as they are uncovered, many abusive transactions remain undiscovered and numerous new transactions are created all the time.

Second, the current *ad hoc* and piecemeal approach to addressing corporate tax shelters is inadequate. The current system is costly and inefficient. Admittedly, recent court decisions [1] denying the purported tax benefits of certain shelter transactions are important. However, these decisions are after-the-fact actions against shelters—they do not prevent the design, marketing, and implementation of new and different shelters. Furthermore, even though Congress has enacted certain legislative changes curbing certain types of shelters, these statutory prohibitions can sometimes be avoided by making certain adjustments to a transaction to avoid the impact of the revised statutory provisions. A global legislative solution is needed to prevent abusive, tax-engineered transactions before they occur. The Treasury Department believes this global solution should include four parts: increased disclosure, changes to the substantial understatement penalty, codification of the economic substance doctrine and sanctions on other parties to the transaction.

Third, while increased disclosure and changes to the penalty regime are necessary to uncover transactions and change the cost/benefit analysis of entering into corporate tax shelters, these remedies are not enough. Accordingly, the Treasury Department continues to believe that it is necessary to codify the economic substance doctrine, thus requiring taxpayers to perform a careful analysis of the pre-tax effects of a potential transaction before they enter into it. The Treasury Department's proposed substantive provision is intended to be a coherent standard derived from the economic substance doctrine as enunciated in a body of case law to the exclusion of less developed, inconsistent decisions. Codification of the doctrine, while not creating a new doctrine, would create a consistent standard so that taxpayers may not choose between the conflicting decisions to support their position. Codification would isolate the doctrine from the facts of the cases so that taxpayers could not simply distinguish the cases based on the facts.

Fourth, there are substantial similarities between the Treasury Department's proposals and other proposals to curb corporate tax shelters. For example, the staff of the Joint Committee on Taxation agrees that there should be increased disclosure by participants, increased penalties on understatements attributable to undisclosed transactions and tightening of the reasonable cause exception, and sanctions on other parties to the transaction. As discussed more fully in the White Paper, the American Bar Association and the New York State Bar Association proposals contain several elements similar to those in the Administration's proposal. Finally, H.R. 2255, introduced by Mr. Doggett, also contains an approach similar to the Administration's proposal, including the codification of the economic substance doctrine. We commend Mr. Doggett for his leadership.

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[1] *See, e.g., Compaq Computer Corp. v. Comm.*, 113 T.C. No. 17 (1999); *IES Industries v. U.S.*, No. C97–206 (N.D. Iowa 1999); *Winn-Dixie Stores, Inc. v. Comm.*, 113 T.C. No. 21 (1999); *Saba Partnership v. Comm.*, T.C. Memo 1999–359 (1999).

Fifth, the proposed legislation would be inadequate without effective enforcement. The Internal Revenue Service is undergoing a substantial restructuring. This restructuring will concentrate IRS resources relating to corporate tax shelters, enabling it to identify, focus on, and coordinate its efforts against corporate tax shelters in a more efficient manner, while instituting and maintaining appropriate taxpayer safeguards. The enactment of corporate tax shelter legislation, combined with the efforts of the restructured IRS, will deter abusive transactions before they occur and uncover and stop these transactions to the extent they continue to occur.

The balance of my testimony will elaborate on these points.

REASONS FOR CONCERN

First, corporate tax shelters are designed to, and do, substantially reduce the corporate tax base. Moreover, corporate tax shelters breed disrespect for the tax system—both by the parties who participate in the tax shelter market and by others who perceive unfairness. A view that well-advised corporations avoid their legal tax liabilities by engaging in tax-engineered transactions may cause a "race to the bottom." The New York State Bar Association recently noted this "corrosive effect" of tax shelters: "The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in tax advantaged transactions." If unabated, this will have long-term consequences to our voluntary tax system far more important than the revenue losses we currently are experiencing in the corporate tax base.

Finally, significant resources—both in the private sector and the government—are currently being wasted on this uneconomic activity.[2] Private sector resources used to create, implement and defend complex sheltering transactions are better used in productive activities. Corporations distort their business decisions to take advantage of tax shelter opportunities. Similarly, the Congress (particularly the tax-writing Committees and their staffs), the Treasury Department, and the IRS must expend significant resources to address and combat these transactions.

CORPORATE TAX SHELTERS AND THE CORPORATE TAX BASE

Some have argued that the growth of corporate income tax receipts demonstrates that corporate tax shelters cannot be a problem. Of course, the size of the problem is not indicated by the *amount* of corporate tax receipts, which vary over time for a number of reasons, but by the *difference* between actual tax payments and those that would be remitted absent corporate tax shelters. That difference is impossible to measure directly, but the increasing difference between the income taxpayers report on their corporate tax forms (taxable income) and the income they report to shareholders (book income) appears to be consistent with the increasing use of corporate tax shelters.

One feature of many tax shelters is that they reduce taxable income and taxes without reducing book income. Corporate taxpayers report their book income on Schedule M–1 of Form 1120. Such data show that the difference between book income and taxable income for large corporations (average assets greater than $1 billion) increased between 1991 and 1996.[3] Current income reported on corporate tax returns (total receipts less total deductions) represented a much smaller share of book income (calculated as book income after tax, plus Federal taxes, less tax-exempt income) in 1996 than in the early 1990s. (See Figure 1.) Thus, even though corporate income reported on tax returns has increased markedly in the 1990s, book income has increased even faster. It is unclear how much of the divergence between tax and book income reflects tax shelter activity, but the data are clearly consistent with other evidence that the problem is significant.

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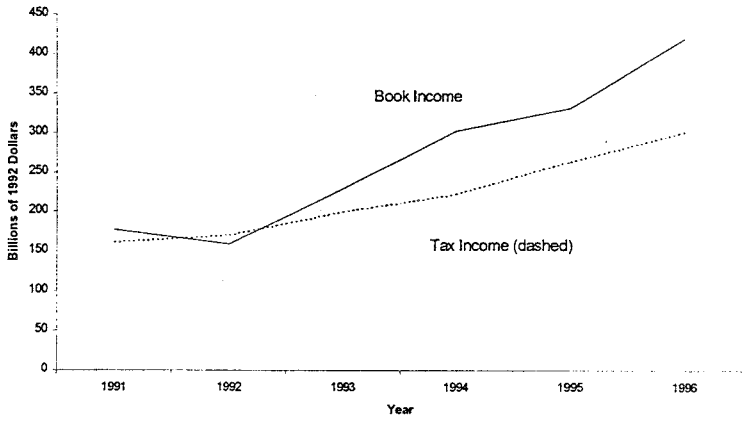
[2] As Peter Cobb, former Deputy Chief of Staff of the Joint Committee on Taxation recently stated: "You can't underestimate how many of America's greatest minds right now are being devoted to what economists would all say is totally useless economic activity."

[3] All estimates are based on a balanced panel of 811 corporations with mean asset size in excess of $1 billion, in 1992 dollars, over the years 1991 through 1996. Corporate tax data are only available through 1996. We did not use data before 1991 for this comparison because depreciation data from Schedule M–1 are not available before 1991. In addition, the detailed book data from before 1991 seem inconsistent with the post–1990 data, perhaps because of an accounting method change.

Figure 1.
Book and Tax Corporate Income
Firms with Mean Assets Over $1 Billion

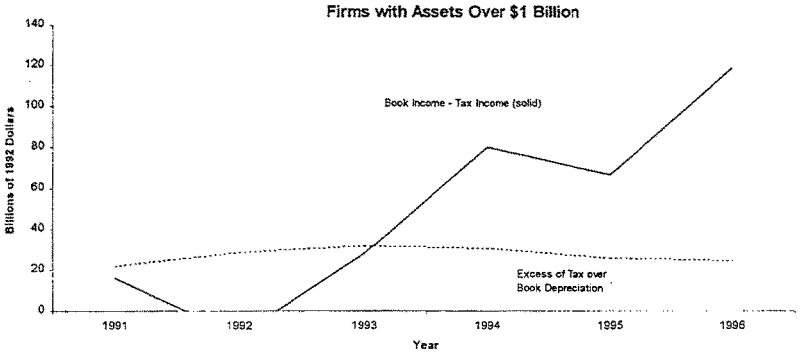


Book Income = After-tax book income from Schedule M-1 + Federal taxes - tax exempt interest
Tax Income = Total Receipts - Total Deductions
Corporations excluding S corporations, RICs, REITs, and Foreign Corporations
Source: Internal Revenue Service, Statistics of Income

Book and tax measures of income can diverge for many reasons that are unrelated to tax shelters. For example, increases in the rate of new investment can cause book and taxable income to diverge because tax depreciation is accelerated compared with book depreciation. But depreciation does not seem to be a significant factor. Figure 2 shows that the difference due to depreciation has declined over the last several years while the difference between book and tax income continues to climb. Hence, removing the depreciation discrepancy would actually make the proportional gap between the two income measures larger in recent years.[4]

[4] Other factors contribute to the gap between book and tax measures of income, including 1) the differential impact of the business cycle on the two measures, 2) increases in foreign based income that are reflected in book but not tax income and 3) differences in accounting treatment for stock options and their increased importance as a component of executive and employee compensation.

Figure 2.
The Difference Between Book and Tax Corporate Income
Firms with Assets Over $1 Billion



Book Income = After-tax book income from Schedule M-1 + Federal taxes - tax exempt interest
Tax Income = Total Receipts - Total Deductions
Corporations excluding S corporations, RICs, REITs, and Foreign Corporations
Source: Internal Revenue Service, Statistics of Income

Need for legislation

To date, most attacks on corporate tax shelters have targeted specific transactions and have occurred on an *ad hoc*, after-the-fact basis—through legislative proposals, administrative guidance, and litigation. In the past few years alone, Congress, the Treasury Department and the IRS have taken a number of actions to address specific corporate tax shelters. These include:

1. Two provisions enacted in 1996 and 1997 to prevent the abuse for tax purposes of corporate-owned life insurance (COLI).[5] Collectively, these two provisions were estimated by the Joint Committee on Taxation to raise over $18 billion over 10 years. As the then Chief of Staff of the Joint Committee on Taxation stated: "When you have a corporation wiring out a billion dollars of premium in the morning and then borrowing it back by wire in the afternoon and instantly creating with each year another $35 million of perpetual tax savings, that's a problem. . . . I think we were looking at a potential for a substantial erosion of the corporate tax base if something hadn't been done."[6]

2. Legislation enacted late last year to eliminate the ability of banks and other financial intermediaries to avoid corporate-level tax through the use of "liquidating REITs."[7] The Treasury Department's Office of Tax Analysis (OTA) estimated that eliminating this one tax shelter product alone would save the tax system approximately $34 billion over the next ten years.

3. The recent IRS ruling[8] addressing so-called lease-in, lease-out transactions, or "LILO" schemes. Like COLI, these transactions, through circular property flows and cash flows, offered participants millions of dollars in tax benefits with no real economic substance or risk. Based on the transactions we have been able to identify to date, OTA estimates that eliminating this tax shelter saved $10.5 billion over ten years.

4. Legislation signed into law on June 25, 1999, aimed at section 357(c) basis creation abuses.[9] In these transactions, taxpayers exploited the concept of "subject to" a liability and claimed increases in the bases of assets that resulted in bases far in excess of the assets' values.

5. Proposed regulations[10] addressing fast-pay preferred stock transactions. These financing transactions purportedly allowed taxpayers to deduct both principal and

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[5] Pub. L. No. 104–191, § 501 (1996); Pub. L. No. 105–34, § 1084 (1997)
[6] Kenneth Kies, *Transcript of Federal Bar Association's Fourth Invitational Biennial Conference on the Tax Legislative Process, reprinted in* 97 Tax Notes Today 21–38 (Jan. 31, 1997).
[7] Pub. L. No. 105–277, § 3001(a) (1998).
[8] Rev. Rul. 99–14, 1994–14 I.R.B. 3.
[9] Pub. L. No. 106–36, § 3001 (1999).
[10] Prop. Reg. § 1.7701(l)–3.

interest. It was reported that one investment bank created nearly $8 billion of investments in a few months.

6. Notice 98–5 [11] dealing with foreign tax credit abuses.

7. The Government's victories in several important corporate tax shelter cases—*ACM Partnership* v. *Commissioner* [12] and *ASA Investerings Partnership* v. *Commissioner*,[13] and those cases mentioned in footnote one of this testimony.

Addressing corporate tax shelters on a transaction-by-transaction, *ad hoc* basis, however, has substantial defects. First, because it is not possible to identify and address all (or even most) current and future sheltering transactions, this type of transaction-by-transaction approach is inadequate. There will always be transactions that are unidentified or not addressed by the legislation. As Treasury Secretary Lawrence H. Summers said: "One is reminded of painting the Brooklyn Bridge: no sooner is one section painted over, than another appears needing work. Taxpayers with an appetite for corporate tax shelters will simply move from those transactions that are specifically prohibited by the new legislation to other transactions the treatment of which is less clear." [14]

Second, addressing tax shelters on a piecemeal basis complicates the tax law. In the past few years alone, Congress has passed numerous provisions to prevent specific tax shelter abuses. The layering of provision upon provision may lead one to believe that there is a rule for every situation and thus what is not specifically proscribed is, by negative inference, allowed. In time these specific rules themselves are used in unintended ways to create corporate tax shelters.[15]

Third, a legislative strategy that deals with tax shelter transactions on a piecemeal basis calls into question the viability of current rules and standards, particularly the common law tax doctrines such as sham transaction, business purpose, economic substance and substance-over-form. Finally, reliance on a transaction-by-transaction legislative approach to corporate tax shelters may embolden some promoters and participants to rush shelter products to market on the assumption that any Governmental reaction would be applied only on a prospective basis.

We believe that a more comprehensive approach to corporate tax shelters is needed. In developing such an approach in the President's FY 2000 Budget and the Treasury Department's White Paper, we examined characteristics of known corporate tax shelters.

Common characteristics

Because corporate tax shelters take many different forms and utilize many different structures, they are difficult to define with a single formulation. A number of common characteristics, however, can be identified that are useful in crafting an approach to solving the corporate tax shelter problem.

Lack of economic substance—Professor Michael Graetz recently defined a tax shelter as "a deal done by very smart people that, absent tax considerations, would be very stupid." [16] This definition highlights one of the most important characteristics common to most corporate tax shelters—the lack of any significant economic substance or risk to the participating parties. Through hedges, circular cash flows, defeasements and the like, the participant in a shelter is insulated from any significant economic risk.

Inconsistent financial accounting and tax treatments—There is a current trend among public companies to treat corporate in-house tax departments as profit centers that strive to keep the corporation's effective tax rate (i.e., the ratio of corporate tax liability to book income) low and in line with that of competitors. Accordingly, in many recent corporate tax shelters involving public companies, the financial accounting treatment of the shelter item has been inconsistent with the claimed Federal income tax treatment.

Tax-indifferent parties—Many recent shelters have relied on the use of "tax-indifferent" parties—such as foreign or tax-exempt entities—who participate in the transaction in exchange for a fee to absorb taxable income or otherwise deflect tax liability from the taxable party.

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[11] 1998–3 I.R.B. 49.

[12] 73 T.C.M. (CCH) 2189 (1997), *aff'd in part, rev'd in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 119 S.Ct. 1251 (1999).

[13] 76 T.C.M. (CCH) 325 (1998).

[14] Lawrence H. Summers, "A Better Tax Service and a Better Tax System," Tax Executives Institute, March 22, 1999.

[15] So far this year, we have shut down so-called "chutzpah trusts" which were similar to a structure shut down by Congress in 1997 and we are now hearing about "son of LILO" transactions and permutations of the section 357(c) product.

[16] *See* Tom Herman, *Tax Report*, Wall St. J. at A–1 (Feb. 10, 1999).

Marketing activity—Promoters often design tax shelters so that they can be replicated multiple times for use by different participants, rather than to address the tax planning issues of a single taxpayer. This allows the shelter "product" to be marketed and sold to many different corporate participants, thereby maximizing the promoter's return from its shelter idea.

Secrecy—Similar to marketing, maintaining secrecy of a tax shelter transaction helps to maximize the promoter's return from its shelter idea—it prevents expropriation by others and it protects the efficacy of the idea by preventing or delaying discovery of the idea by the Treasury Department and the IRS. In the past, many promoters have required prospective participants to sign a non-disclosure agreement that provides for large payments for any disclosure of the "proprietary" advice.

Contingent or refundable fees and rescission or insurance arrangements—Corporate tax shelters often involve contingent or refundable fees in order to reduce the cost and risk of the shelter to the participants. In a contingent fee arrangement, the promoter's fee depends on the level of tax savings realized by the corporate participant. Some corporate tax shelters also involve insurance or rescission arrangements. Like contingent or refundable fees, insurance or rescission arrangements reduce the cost and risk of the shelter to the participants.

High transaction costs—Corporate tax shelters carry unusually high transaction costs. For example, the transaction costs in the *ASA Investerings Partnership case* ($24,783,800) were approximately 26.5 percent of the purported tax savings (approximately $93,500,000).

Administration proposals

In its FY 2000 Budget, the Administration made several proposals designed to inhibit the growth of corporate tax shelters. These proposals build upon the common characteristics of corporate tax shelters described above and focus on the following areas:

(1) increasing disclosure of corporate tax shelter activities,

(2) increasing and modifying the penalty relating to the substantial understatement of income tax,

(3) codifying the economic substance doctrine, and

(4) providing consequences to all the parties to the transaction (e.g., promoters, advisors, and tax-indifferent, accommodating parties).

Increasing disclosure

Greater disclosure of corporate tax shelters would aid the IRS in identifying corporate tax shelters and would therefore lead to better enforcement by the IRS. Also, greater disclosure likely would discourage corporations from entering into questionable transactions. The probability of discovery by the IRS should enter into a corporation's cost/benefit analysis of whether to enter into a corporate tax shelter.

In order to be effective, disclosure must be both timely and sufficient. In order to facilitate examination of a particular taxpayer's return with respect to a questionable transaction, the transaction should be prominently disclosed on the return. Moreover, because corporate tax returns may not be examined for a number of years after they are filed, an "early warning" system should be required to alert the IRS to tax shelter "products" that may be promoted to, or entered into by, a number of taxpayers. Disclosure should be limited to the factual and legal essence of the transaction to avoid being overly burdensome to taxpayers.

Disclosure would be required if a transaction has certain of the objective characteristics identified above that are common in many corporate tax shelters. The Treasury Department believes that two forms of disclosure are necessary. Disclosure would be made on a short form separately filed with the National Office of the IRS. Promoters would be required to file the form within 30 days of offering the tax shelter to a corporation. Corporations entering into transactions requiring disclosure would file the form by the due date of the tax return for the taxable year for which the transaction is entered into (unless the corporation had actual knowledge that the promoter had filed with respect to the transaction) and would include the form in all tax returns to which the transaction applies. The form would require the taxpayer to provide a description of the characteristics that apply to the transaction and information similar to the information in the ABA disclosure proposal. The form should be signed by a corporate officer who has, or should have, knowledge of the factual underpinnings of the transaction for which disclosure is required. Such officer should be made personally liable for misstatements on the form, with appropriate penalties for fraud or gross negligence and the officer would be accorded appropriate due process rights.

Substantial understatement penalty

In order to serve as an adequate deterrent, the risk of penalty for corporations that participate in corporate tax shelters must be real. The penalty also must be sufficient to affect the cost/benefit analysis that a corporation considers when entering into a tax shelter transaction.

The Treasury Department believes that the substantial understatement penalty imposed on understatements of tax attributable to corporate tax shelters should be greater than the penalty generally imposed on other understatements. This view is shared by the staff of the Joint Committee on Taxation, the ABA, the NYSBA and others. Thus, to discourage the use of shelters, the Treasury Department would double the current-law substantial understatement penalty rate to 40 percent for corporate tax shelters. To encourage disclosure, the penalty rate would be reduced to 20 percent if the taxpayer files the appropriate disclosures.

In the original Budget proposal, the Administration provided that the rate could not be further reduced below 20 percent or eliminated by a showing of reasonable cause (i.e., the penalty would be subject to a strict liability standard). Although one may rhetorically question whether there ever is any reasonable cause for entering into a corporate tax shelter transaction, many commentators have criticized the proposed elimination of the reasonable cause exception for corporate tax shelters. These commentators cited the potentially vague definitions of corporate tax shelter and tax avoidance transaction,[17] the allowance of a reasonable cause exception for other penalties, and basic fairness for opposing a "strict liability" penalty. The Treasury Department still believes that the penalty structure set forth in the Administration's FY 2000 Budget is appropriate. However, in light of the comments received, the Treasury Department believes that consideration should be given to reducing or eliminating the substantial understatement penalty where the taxpayer properly discloses the transaction and the taxpayer has a reasonable belief that it has a strong chance of sustaining its tax position. In addition, because many commentators believe that taxpayers are either ignoring or circumventing the requirements of Reg. § 1.6664–4 as to what constitutes reasonable cause, these requirements would be codified to heighten visibility and strengthened to the extent necessary.

Under the Treasury Department's modified approach, a strengthened reasonable cause standard could be used to reduce or eliminate the substantial understatement penalty if the taxpayer also properly disclosed the transaction in question, even if the transaction ultimately is deemed to be a corporate tax shelter. This limited exception would encourage disclosure and would alleviate some taxpayer concerns with respect to the definition of corporate tax shelter.

Finally, as discussed below, fears that the IRS may abuse the potential availability of increased substantial understatement penalties would be addressed by establishing procedures that would enhance issue escalation and facilitate consistent and centralized resolution of such matters.

Codify the economic substance doctrine

As evidenced by the comments from the ABA, AICPA, NYSBA, and others, corporate tax shelters are proliferating under the existing legal regime. This proliferation results, in part, because discontinuities in objective statutory or regulatory rules can lead to inappropriate results that have been exploited through corporate tax shelters. Current statutory anti-abuse provisions are limited to particular situations and are thus inapplicable to most current corporate tax shelters. Further, application of existing judicial doctrines has been inconsistent over time, which encourages the most aggressive taxpayers to pick and choose among the most favorable court opinions.

The current piecemeal approach to addressing corporate tax shelters has proven untenable, as (1) policymakers do not have the knowledge, expertise and time to continually address these transactions; (2) adding more mechanical rules to the Code adds to complexity, unintended results, and potential fodder for new shelters; (3) the approach may reward taxpayers and promoters who rush to complete transactions before the anticipated prospective effective date of any reactive legislation; and (4) the approach results in further misuse and neglect of common law tax doctrines. Thus, the Treasury Department believes that a codification of the economic substance doctrine is necessary in order to curb the growth of corporate tax shelters. While increased disclosure and changes to the penalty regime are necessary to escalate issues and change the cost/benefit analysis of entering into corporate tax shel-

[17] These criticisms were addressed by the Treasury Department by modifying the definition of these terms.

ters, these remedies are not enough if taxpayers continue to believe that they will prevail on the underlying substantive issue.

The centerpiece of the substantive law proposal is the codification of the economic substance doctrine first found in seminal case law such as *Gregory* v. *Helvering*[18] and most recently utilized in *ACM Partnership*[19] and the cases in footnote one. The economic substance doctrine requires a comparison of the expected pre-tax profits and expected tax benefits. This test is incorporated in the first part of the Administration's proposed definition of "tax avoidance transaction." Under that test, a tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, the economic substance doctrine would apply to financing transactions (that do not lend themselves to a pre-tax profit comparison) by comparing the tax benefits claimed by the issuing corporation to the economic profits derived by the person providing the financing.

A tax benefit would be defined to include a reduction, exclusion, avoidance or deferral of tax, or an increase in a refund. However, the definition of tax benefit subject to disallowance would not include those benefits that are clearly contemplated by the applicable Code provision (taking into account the Congressional purpose for such provision and the interaction of the provision with other provisions of the Code). Thus, tax benefits that would normally meet the definition, such as the low-income housing credit and deductions generated by standard leveraged leases, would not be subject to disallowance.

The above definition of a tax-avoidance transaction is a modification of the Administration's original FY 2000 Budget proposal. The modifications address commentators' concerns about the potential vagueness of the original proposal. Concerns that the IRS might abuse the authority indicated in the original Budget proposal are addressed by a more concrete definition of tax avoidance transaction. In addition, the tax attribute disallowance rule would apply by operation of law, rather than being subject to the discretion of the Secretary.

A similar approach to that discussed above can be found in H.R. 2255, the "Abusive Tax Shelter Shutdown Act of 1999," introduced by Messrs. Doggett, Stark, Hinchey and Tierney on June 17, 1999.

The Treasury Department continues to believe that it is necessary to codify the economic substance doctrine, thus requiring taxpayers to perform a careful analysis of the pre-tax effects of a potential transaction before they enter into it. The Treasury Department's proposed substantive provision is intended to be a coherent standard derived from the economic substance doctrine as enunciated in a body of case law to the exclusion of less developed, inconsistent decisions. Codification of the doctrine, while not creating a new doctrine, would create a consistent standard so that taxpayers may not choose between the conflicting decisions to support their position. Codification would isolate the doctrine from the facts of the cases so that taxpayers could not simply distinguish the cases based on the facts.

Consequences to other parties

Proposals to deter the use of corporate tax shelters should provide sanctions or remedies on other parties that participate in, and benefit from, a corporate tax shelter. These remedies or sanctions would reduce or eliminate the economic incentives for parties that facilitate sheltering transactions, thus discouraging those transactions. As the ABA stated in its recent testimony: "All essential parties to a tax-driven transaction should have an incentive to make certain that the transaction is within the law." With respect to corporate tax shelters, the "other parties" generally are promoters, advisors, and tax-indifferent parties that lend their tax-exempt status to the shelter transaction to absorb or deflect otherwise taxable income.

When Congress was concerned with the proliferation of individual tax shelters in the early 1980s, it enacted several penalty and disclosure provisions that applied to advisors and promoters. These provisions were tailored to the types of "cookie-cutter" tax shelter products then being developed. Similar provisions could be enacted that are tailored to corporate tax shelters.

Alternatively, with respect to promoters and advisors of corporate tax shelters, the Treasury Department proposed to affect directly their economic incentives by levying an excise tax of 25 percent upon the fees derived by such persons from the corporate tax shelter transaction. Only persons who perform services in furtherance of

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[18] 293 U.S. 465 (1935).

[19] *ACM Partnership* v. *Comm.*, 73 T.C.M. (CCH) 2189, *aff'd in part, rev'd in part*

the corporate tax shelter would be subject to the proposal, and appropriate due process procedures for such parties with respect to an assessment would be provided.

A tax-indifferent party often has a special tax status conferred upon it by operation of statute or treaty. To the extent such person is using this status in an inappropriate or unforeseen manner, the system should not condone such use. Imposing a tax on the income allocated to tax-indifferent parties could deter the inappropriate rental of their special tax status, limiting their participation in corporate tax shelters, and thus reducing other taxpayers' use of shelters that utilize this technique.

The Treasury Department proposes to require tax-indifferent parties to include in income (either as unrelated business taxable income or effectively connected income) income earned in a corporate tax shelter transaction. To the extent such parties are outside the U.S. tax jurisdiction, such liability would be joint and severable with the U.S. corporate participant. The proposal would apply only to tax-indifferent parties that are trading on their special tax status and such parties would have appropriate due process rights.

JCT Report

The staff of the Joint Committee on Taxation (JCT), in its study and report on penalty and interest provisions of the Code, also analyzes corporate tax shelters. The JCT staff concluded that there "is evidence that the use of corporate tax shelters has grown significantly in recent years" and "that present law does not sufficiently deter corporations from entering into arrangements with a significant purpose of avoiding or evading Federal income tax." In this regard, the staff made certain legislative recommendations.

The proposals made by the JCT staff are quite similar to those made by the Administration. The JCT staff proposal would require increased disclosure, increase the substantial understatement penalty on undisclosed transactions and tighten the reasonable cause standard, and provide sanctions on other parties to shelter transactions. The major difference between the two sets of recommendations is that the JCT would not codify the economic substance doctrine. However, the JCT proposal does incorporate a version of the economic substance doctrine similar to that of the Administration's proposals in identifying corporate tax shelters.

Compaq and other recent decisions

Since we last testified before this Committee on the problem of corporate tax shelters, the IRS has won some significant tax shelter cases, including *Compaq, IES Industries, Winn-Dixie, and Saba Partnership*. The courts in these cases applied an economic substance analysis in denying tax benefits that purportedly met the black letter of the applicable Code provisions.

These cases are helpful as part of an overall approach to address corporate tax shelters. First, the cases stand for the proposition that both the economic substance doctrine and the role of penalties are important components in the fight against corporate tax shelters. Some may argue that these cases demonstrate that the IRS currently has all the tools it needs to combat corporate tax shelters and that further legislation is unnecessary. Such an assertion ignores the realities of the litigation process and is premised on a misunderstanding of the intent of the Administration's legislative proposals.

Reliance on judicial decisions, which taxpayers may attempt to distinguish, is not the most efficient means of addressing corporate tax shelters. Litigation is expensive and time-consuming, both for the government and taxpayers, and frequently does not provide a coherent set of rules to be applied to subsequent transactions. Tax Court Judge Laro, speaking on his own behalf before the Tax Executives Institute last month,[20] acknowledged that the courts have provided little guidance on the amount of economic substance or business purpose sufficient for a transaction to be respected. He stated that such concepts "may require further development in the case law," but highlighted the difficulty with such an approach when he said that judges "decide cases one at a time...and don't make tax policy."

The Treasury Department strongly believes that the economic substance doctrine upon which these recent cases have been decided should be codified. The doctrine has been a part of the fabric of our tax system since the seminal case of *Gregory* v. *Helvering*, but has, until recently, been eroded by some admittedly confusing and conflicting case law that has led to a lack of respect for the doctrine on the part of some taxpayers and tax practitioners. The economic substance doctrine is the most objective, most understandable, and most easily applied of all the judicially created doctrines. We believe that it is appropriate for the Congress to elevate this

[20] *BNA Daily Tax Report* (Oct. 28, 1999), G–2.

standard by codifying it, rather than waiting and hoping that the case law evolves in a more coherent and understandable manner.

The Administration's corporate tax shelter proposals, including enactment of the economic substance doctrine, attempt to change the outcome of the cost-benefit analysis undertaken by taxpayers in deciding whether or not to engage in a questionable transaction. Taxpayers should be encouraged to apply these principles before the fact, rather than playing the audit lottery. The Administration's proposals provide a level playing field between overly aggressive taxpayers and compliant taxpayers and between overly aggressive taxpayers and their advisors and the government by ensuring that all parties are playing by the same objective rules, encouraging timely disclosure of potentially questionable transactions, and providing appropriate sanctions to parties that "cross the line."

IRS administrative actions

The IRS currently is undergoing a substantial restructuring. The IRS will be reorganized into divisions based on types of taxpayers. Because the Treasury proposals generally apply to large corporate transactions, the IRS personnel focusing on corporate shelters probably will be located in the IRS's new Large and Mid-Size Business Division, which will be fully operational in 2000.

The restructuring of the IRS will enhance its ability to deal with corporate tax shelters. Centralization of IRS resources focusing on corporate tax shelters will facilitate training and coordination among IRS agents, IRS litigators, their supervisors and Chief Counsel. The IRS also is considering methods to centralize and coordinate the formulation of strategy regarding corporate shelters generally and particular shelter transactions.

Further, to prevent interference with legitimate business transactions, the IRS is considering whether to require examining agents to refer corporate tax shelter issues to a centralized office for consideration. Such a referral process might be similar to that used with respect to the partnership anti-abuse regulations. The IRS is also considering whether to establish of a procedure whereby a taxpayer could obtain an expedited ruling from the IRS as to whether a contemplated transaction constitutes a corporate tax shelter.

The Treasury Department will work closely with the IRS to create appropriate systems and procedures to centralize review and analysis, to ensure fair, consistent, and expeditious consideration of corporate tax shelter issues.

Conclusion

Mr. Chairman, the proliferation of corporate tax shelters presents an unacceptable and growing level of tax avoidance behavior by wasting economic resources, reducing tax receipts, and threatening the integrity of the tax system. This morning we have laid out the rationale for our suggested approach for combating this problem, and discussed why we believe that existing law does not provide sufficient tools to combat this behavior. We look forward to working with you and the members of the Committee to address this important problem, as we have in the past to curb specific abuses.

[The Attached July 1999 "White Paper" by the U.S. Department of the Treasury, Entitled, "The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals," is Being Retained in the Committee Files, and is also available at WWW.USTREAS.GOV/TAXPOLICY/LIBRARY/CTSWHITE.PDF.]

Mr. MCCRERY. Ms. Paull.

STATEMENT OF LINDY PAULL, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Ms. PAULL. Thank you, Mr. Chairman, members of the Committee. I am pleased to present the testimony of the staff of the Joint Committee on Taxation today.

My testimony focuses on the staff's recommendations that were made in the penalties and interest study that was released in July. That study was mandated by the IRS Reform Act and included, in addition to corporate tax shelter recommendations, recommendations on other penalties and interest provisions of the Tax Code

which I hope the Committee will have the opportunity to look at in the near future.

Attached to my testimony today are two documents. One, the first attachment, is a compilation of some data with respect to income tax receipts—broken down by individual, corporation and total receipts as well as GDP for the period, so that the Committee can have our data on these matters. And, in addition, we have a second table in that first attachment that provides some information on corporate income during the last decade basically.

The second attachment to our testimony is a very lengthy document. I apologize to the Committee for not providing it earlier. It is difficult to come to closure on some of these documents. In this document, we attempted to compile all of the concerns raised with respect to both the Treasury proposals, Mr. Doggett's proposals, and, in the interest of fair play, the Joint Tax Committee staff's recommendations.

So we hope this will be a useful document as the Committee gives further consideration to this issue, because there are lots of issues as you go about trying to deal with this very complicated matter.

In conducting our study, we did a very comprehensive review of the substantive laws under the Tax Code, the various common law doctrines that the courts used to evaluate potentially abusive transactions and the standards of practice that apply to the tax advisers that participate with the investors in these transactions.

We spent a considerable amount of time meeting with people, analyzing the various proposals, and trying to sort out the best we can where we are on this particular issue. We believe, as is stated in our report and in our testimony, that there is a problem with corporate tax shelters. We believe it is a growing problem, and we have to say that we don't have hard data on that.

I don't think anybody has any hard data on that. Much of the evidence dealing with this kind of a subject is anecdotal that we get all the time from tax practitioners, corporations across the country talking to us about transactions, so it is that source of anecdotal testimony discussions that our staff gets. And all the kind of groups that have been testifying before Congress this year have indicated there is a growing problem with corporate tax shelters—I think it would be hard to ignore that there is a growing problem here.

Although we have provided you with our income tax receipt data, we would caution you about the use of it and pointing to it, saying that this is evidence of corporate tax shelter activity. I don't think anybody, the Treasury Department or our staff, would be able to tell you that that data tells you very much. We don't have a good, comprehensive analysis of what the data means. And I think that it is only fair to say that there are a lot of factors at play here. There is a growing use of subchapter S corporations and other types of pass-through entities that could well be significant in looking at corporate receipts.

On the other hand, if you do look at the corporate income tax receipts that are shown in the table, table 1 of attachment 1, you will see that corporate receipts are basically flat over the last couple of

years. In fact, the most recent reports indicates they have gone down slightly, when we have a growing economy.

So there is an issue there. We don't have any hard data that would tell you what is causing the decline in corporate income tax receipts. I would caution you on the use of macroeconomic statistics in going about analyzing this problem.

As Mr. Talisman said, there have been some recent court cases that dealt with some very aggressive transactions, and we have been trying to get as much information as we can about other similar cases that might be in the pipeline, and we have provided some data in my testimony about that.

We believe there are at least eight other cases outstanding involving the same kind of issues that are involved in the ACM case and the total tax involved, which might span a number of years, is roughly in the range of a billion dollars for that one issue.

Another recent case dealt with the Compaq Computer Corporation. We believe that there is at least 15 other cases outstanding involving the same issue there and possibly quite a few more. Those 15 cases might involve about approximately $60 million in taxes.

And Winn-Dixie, another very recent case that dealt with corporate-owned life insurance, we believe there is as many as 100 similar cases outstanding dealing with similar issues which may involve about $6 billion in taxes.

So if you add up those three transactions that were the subject of recent court cases where the courts held that the transactions that were entered into basically do not have any economic substance or they were possibly a sham in one instance, you will see over a short period of time about $7 billion in play, according to our statistics, and we believe they are conservative statistics. So while we don't have hard evidence about what is happening to corporate income tax receipts, we do have some evidence about questionable transactions that are in the pipeline and in controversy at the current time.

Those cases are early 1990 cases. What we have been hearing from practitioners and from corporate insiders is that the activity with respect to these type of aggressive transactions has been occurring more and more in recent years. So there is a disconnect here between that kind of data, which involves transactions that date back to the early 1990s, and what is happening now.

All I can say is I think the Treasury Department and our staff will be monitoring and trying to provide the best data we can provide to the Committee as we get it during this process.

With respect to the reason why a corporate tax shelter problem exists, we identified the penalty regime as a real problem under current law. We don't think the chances of getting hit with a penalty are very great.

Again, we have taken a look at the most recent data on how much penalties in the nature of underpayment penalties or negligence penalties are paid by corporations. They are extremely small compared to the dollars that are outstanding in controversy and the dollars that are paid after a tax return is filed by corporations. So we believe there is a significant problem here with respect to the penalty regime. Because when a corporation or anybody en-

ters into a business transaction, the analysis they do is a cost-benefit analysis: What is the costs of doing the transaction and what benefits am I going to derive from the transaction?

And, right now, we believe that the cost-benefit analysis is tilted in favor of going forward with more aggressive transactions because the downside is very low. Very rarely will there be a penalty. You only have to pay the tax if you get caught on audit, so you play the audit lottery with these transactions. And it may take a long time to come to a resolution. If you have to go to court, it could take 4 or 5 years to resolve the issue. During that period, you have the use of the money.

So the real downside is that you might pay some interest on this money that you end up paying if you get caught. So we think, after quite a bit of analysis, that the proper way to approach the corporate tax shelter problem is to look at the penalty regime and see if you can address the issue of increasing the stakes and the costs of these types of transactions.

Mr. HOUGHTON. [presiding.] Ms. Paull, how much longer do you think you will be?

Ms. PAULL. I think I need about 4 more minutes.

Mr. HOUGHTON. All right.

Ms. PAULL. We have really struggled with the notion of trying to codify the court cases on this subject. And that, of course, is one of the approaches the Treasury Department has taken and Mr. Doggett in his legislation tries to take.

You know, when you try to codify those cases, you end up having to go down the road, I think, of exempting out various transactions or investments. In the case of the Treasury Department, they put in this notion of clearly contemplated by the Tax Code. Your transaction might be in trouble unless it is clearly contemplated by the Tax Code.

Mr. Doggett's legislation says your transaction might be in trouble unless you are on the good list, so to speak. He provides a list of some good items in the Tax Code and then allows the Treasury Department to add to the list. This is the most difficult thing you will need to focus on here is what is a corporate tax shelter. It is not susceptible, in our view, of an easy definition.

We do attempt to identify the indicators of the modern day corporate tax shelter for purposes of beefing up the penalty regime.

But for purposes of determining your underlying tax liability, this is a very, very difficult thing to do. And I would caution the Committee on that in that regard. And as I said before, we have more fully presented those kinds of issues in this document that is before you today, appendix number 2.

If I might just briefly summarize the specific recommendations that the Joint Committee staff did in its report this summer. We believe the current penalty regime should be strengthened. In order to do that, you have to come to some grips with what is the kind of transaction that you want to hit with a strengthened penalty. So we have set forth some indicators of a corporate tax shelter, which I will not go into now, but I would be happy to discuss with anybody.

We also would modify the penalty so there would be no requirement that there is a substantial understatement. For a large cor-

poration, the current penalty regime gives, in essence a fudge factor of 10 percent of the taxes that should be known on a return.

We would also elevate the standards for getting out of the penalty, and we would ask that the penalty be increased from 20 to 40 percent.

In addition, we have a series of proposals that are directed at advisors or other participants in the transactions. And we also have a series of disclosure and registration requirements not unlike in the other bills.

So with that, I would welcome the opportunity to answer any questions you may have and look forward to working with you as you try to grapple with this very difficult issue.

Mr. HOUGHTON. We do, too, and thanks very much, Ms. Paull.

[The prepared statement follows:]

Statement of Lindy Paull, Chief of Staff, Joint Committee on Taxation

My name is Lindy Paull. As Chief of Staff of the Joint Committee on Taxation, it is my pleasure to present the written testimony of the staff of the Joint Committee on Taxation (the "Joint Committee staff") at this hearing before the House Committee on Ways and Means concerning corporate tax shelters.[1]

My testimony today focuses on recommendations made by the Joint Committee staff with respect to corporate tax shelters, which are contained in Part VIII of the study prepared by the Joint Committee staff regarding the present-law penalty and interest provisions.[2] Two attachments supplement my testimony. The first attachment provides data on Federal income tax receipts and corporate income.[3] The second receipt attachment is our staff's further analysis of the issues presented by corporate tax shelter proposals and recommendations.[4]

I. BACKGROUND

Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 directed the Joint Committee on Taxation and the Secretary of the Treasury to conduct separate studies of the present-law interest and penalty provisions of the Internal Revenue Code (";Code") and to make any legislative or administrative recommendations to the House Committee on Ways and Means and the Senate Committee on Finance that are deemed appropriate to simplify penalty and interest administration or reduce taxpayer burden. The Joint Committee staff study makes a number of recommendations with respect to non-corporate tax shelter penalties and interest that will be the subject of a separate hearing by the Subcommittee of Oversight of the House Committee on Ways and Means.

The Joint Committee staff recommendations regarding corporate tax shelters were the product of an extensive review and analysis of the present-law system of penalties and interest in the Code. The Joint Committee staff study focused on sanctions in the Code that relate to the collection of the proper amount of tax liability, such as penalties relating to payment of the proper amount of tax, reporting of income, and failure to provide information returns or reports.

The penalty provisions reviewed by the Joint Committee staff relating to tax shelters include the following:

(1) The accuracy-related penalty imposes a 20 percent penalty on any substantial understatement of income tax that, among other things, is attributable to corporate tax shelters.[5]

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[1] This testimony may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Before the House Committee on Ways and Means* (JCX–82–99), November 10, 1999.

[2] Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (JCS–3–99), July 22, 1999 (";Joint Committee staff study").

[3] Joint Committee on Taxation, *NIPA and Federal Income Tax Receipts Data* (JCX–83–99), November 10, 1999.

[4] Joint Committee on Taxation, *Description and Analysis of Present-Law Tax Rules and Recent Proposals Relating to Corporate Tax Shelters* (JCX–84–99), November 10, 1999.

[5] Code section 6662.

(2) Income tax return preparers may be liable for a penalty with respect to an understatement of a taxpayer's liabilities.[6]
(3) Penalties may be imposed on those who aid and abet a taxpayer with respect to a return that results in an understatement of tax liability.[7]
(4) Penalties may be imposed on those who promote abusive tax shelters.[8]
(5) Registration requirements apply with respect to tax shelters[9] and penalties are imposed for failing to comply with the registration requirements.[10]

The Joint Committee staff concluded after reviewing the above provisions that a comprehensive study of the present-law penalty provisions of the Code relating to tax shelters was appropriate.

II. METHODOLOGY

The Joint Committee staff conducted a comprehensive review of the penalty and interest rules applicable to corporate tax shelters and evaluated their effectiveness in dealing with modern-day corporate tax shelter transactions. As part of the review process, the Joint Committee staff analyzed:

(1) The substantive laws in the Code that are designed to, among other things, deter tax-shelter transactions[11] and their interaction with the penalty and interest rules,
(2) The various common-law doctrines used by the courts to evaluate and potentially disallow tax benefits claimed in tax shelter transactions[12] and the imposition of penalties with respect to these transactions, and
(3) The standards of practice that affect certain advisors in connection with tax shelter activity and which are intended to have certain deterrent and punitive aspects.[13]

The Joint Committee staff spent considerable time analyzing a variety of recent transactions that have given rise to recent Congressional or Administrative responses. The Joint Committee staff economists analyzed the economic considerations that affect corporate taxpayers' decisions with respect to engaging in tax shelter activity. The Joint Committee staff consulted with representatives of the Treasury Department, and reviewed various comments and proposals that have been put forward with regard to corporate tax shelters, including:

(1) The Administration's proposals that were included in the FY 2000 Budget, as supplemented by the Treasury White Paper on corporate tax shelters,
(2) H.R. 2255, The Abusive Tax Shelter Shutdown Act of 1999, introduced on June 17, 1999 by Congressman Doggett and others,
(3) Comments and recommendations submitted by various groups to this Committee and the Senate Committee on Finance, including groups such as the Tax Executives Institute, the American Bar Association Section of Taxation, the New York State Bar Association Tax Section, and the American Institute of Certified Public Accountants, and
(4) Comments that were submitted to the Joint Committee staff in connection with the Joint Committee staff study.

III. ANALYSIS

In analyzing the effectiveness of the present-law penalty provisions with respect to corporate tax shelters, the Joint Committee staff first addressed two fundamental questions. The first question is whether there is, in fact, a corporate tax shelter problem. If there is a corporate tax shelter problem, the second question is why such a problem exists.

A. The Corporate Tax Shelter Problem

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[6] Code sections 6694 and 6695.
[7] Code section 6701.
[8] Code section 6700.
[9] Code sections 6111 and 6112.
[10] Code sections 6707 and 6708.
[11] Code sections 269, 446, 482 and 7701(l).
[12] The common-law doctrines include the sham transaction doctrine, the economic substance doctrine, the business purpose doctrine, the substance over form doctrine, and the step transaction doctrine.
[13] *See* regulations found in Title 31, Part 10 of the Code of Federal Regulations. In addition, the Joint Committee staff reviewed various standards of practice and rules of professional conduct of the American Bar Association, the American Institute of Certified Public Accountants, and general state licensing authorities.

The Joint Committee staff believes that there is a corporate tax shelter problem—more corporations are entering into arrangements principally to avoid tax. The Joint Committee staff believes the problem is becoming widespread and significant.

Some commentators and interested parties question whether there is a corporate tax shelter problem. They contend that the heightened scrutiny the issue has received this year is mostly attributable to recent press reports. These commentators cite the lack of economic data showing a decline in corporate tax receipts as an indication that no problem exists.

Admittedly, much of the evidence in this area is anecdotal, as one might expect, but the importance of this evidence should not be discounted. The parties involved in developing, marketing, or implementing a tax shelter generally benefit by keeping its existence confidential. For example, some firms intentionally limit the sale of a corporate tax shelter that involves tens of millions of dollars in tax savings to only a few taxpayers in an attempt to shield the arrangement from scrutiny by the Congress and the Treasury Department. The existence of the tax shelter is revealed only when a potential customer or a competitor anonymously disclosed the arrangement to a government official.

Recent data would suggest that corporate tax receipts are not keeping pace with a growing economy. Data just released shows that for fiscal year 1999, corporate income tax receipts actually *fell* by approximately $4 billion, representing a decline of approximately two percent, from the prior fiscal year.[14] The last year in which there was a decline in corporate tax receipts was in fiscal year 1990, a period in which the economy was softening and entering the brief recession which began in the last half of 1990.

Commentators and interested parties have relied on macroeconomic data to reach differing opinions regarding whether there is a corporate tax shelter problem. The Joint Committee staff believes that the data are not sufficiently refined to provide a reliable measure of the corporate tax shelter activity. Many tax shelter transactions distort the reported measure of corporate profits in a manner similar to their impact on the corporate tax base. Other factors include year-to-year changes in corporate economic losses and the increased use of non-corporate entities.

The Joint Committee staff believes that direct measurement of corporate tax shelter activity through macroeconomic data is not possible. Instead of focusing on macroeconomic data, a more instructive approach is to analyze specific tax shelter transactions that have come to light and evaluate their effect on corporate receipts. Because this approach only considers a few of the corporate tax shelter transactions, it necessarily understates the size of the corporate tax shelter problem. This approach, nonetheless, provides a useful reference point for consideration of the size of the problem. In the past two years, the courts have disallowed tax benefits in several high-profile corporate tax shelter cases. For example, in *ACM Partnership v. Commissioner*,[15] the Third Circuit Court of Appeals disallowed a capital loss claimed in 1991 from a partnership arrangement because the arrangement lacked economic substance. The amount of the tax savings with respect to this case was approximately $30 million. The Joint Committee staff understands that there are at least eight other cases which raise issues similar to those described in the *ACM* case. The Joint Committee staff further understands that the amount in controversy from these cases (which may span several tax years), when added to the tax benefit at issue in *ACM*, would total approximately $1 billion in taxes.

A second recent corporate tax shelter case is *Compaq Computer Corp. v. Commissioner*.[16] In the *Compaq* case, the Tax Court disallowed a foreign tax credit claimed in 1992 with respect to a dividend from stock in a foreign corporation. The taxpayer bought and sold the stock within one hour in an arrangement that was structured to eliminate the taxpayer's economic risk from owning the stock. The disallowed tax credit in the *Compaq* case would have resulted in a tax benefit of approximately $3 million. The Joint Committee staff understands that there may be at least 15 other cases which raise issues similar to those described in the *Compaq* case. The Joint Committee staff further understands that, when added to amount at issue in the *Compaq* case, the total amount in controversy with respect to these cases, which may span several tax years, is approximately $60 million in taxes.

A third recent corporate tax shelter case is *Winn-Dixie Stores, Inc. v. Commissioner*.[17] In the *Winn-Dixie* case, the Tax Court disallowed the interest deductions attributable to the taxpayer's 1993 leveraged corporate-owned life insurance

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[14] Monthly Treasury Statement regarding Budget Results for Fiscal Year 1999, Department of the Treasury (October 27, 1999).

[15] 157 F.3d 231 (3d Cir. 1998), aff'g 73 T.C.M. (CCH) 2189 (1997).

[16] 113 T.C. No. 17 (September 21, 1999).

[17] 113 T.C. No. 21 (October 19, 1999).

("COLI") program on the grounds that it lacked both economic substance and business purpose. The amount of purported tax savings in the *Winn-Dixie* case was approximately $1.6 million for one year of an arrangement that was intended to yield tax benefits annually over a 60-year period. The Joint Committee staff understands that there may be as many as 100 cases in controversy which raise issues similar to those described in the *Winn-Dixie* case. The Joint Committee staff also understands that the amount in controversy with respect to these cases, which may span several tax years, is expected to approach approximately $6 billion in taxes.

Looking only at the three arrangements that were at issue in these cases, it is estimated that these cases represent over $7 billion in unpaid corporate taxes (approximately $1 billion from *ACM* and similar cases, approximately $60 million from *Compaq* and similar cases, and approximately $6 billion from *Winn-Dixie* and similar cases). Although these cases represent different tax years, this amount most likely represents a fraction of the corporate tax that the Federal government is not collecting because of corporate tax shelters. In many cases, the corporation that claims the tax benefits from a tax shelter escapes audit, or the tax shelter arrangement goes undetected during an audit. Even when the corporation is audited and the transaction is discovered, the hazards of litigation, the complexities of these transactions, and other factors are such that the IRS often may opt for a negotiated settlement. Only a fraction of tax shelter activity actually results in a judicial determination. In addition, as the these cases illustrate, several years may pass before a judicial determination is made with respect to a corporate tax shelter transaction, during which time similar transactions go undeterred. Thus, even though the outcome of the recent cases generally is favorable to the government, the case law (1) cannot be viewed to be representative of the full magnitude of the problem, and (2) cannot be considered as evidence that the corporate tax shelter problem is being contained.

An additional observation regarding the effect of tax shelters on corporate tax receipts bears discussion. The magnitude of the problem, be it a $10 million loss or a $10 billion loss, is in some respects a secondary issue. Practitioners indicate they are spending more of their time advising corporate clients regarding arrangements that are highly suspect, and tax executives complain they are getting "pitched" more and more "aggressive" transactions from promoters and advisors that are solely motivated to reduce the corporation's effective tax rate without any relation to a nontax business purpose or economic substance. Practitioners and corporate tax executives feel pressured to participate in such transactions, particularly when it appears that the corporation's competitor is doing a similar transaction and getting professional advice that such a transaction can avoid penalties because the professional advisor is willing to opine that the transaction is "more likely than not" to succeed. The perception of potentially becoming competitively disadvantaged by others engaging in a tax-motivated transaction could result in more corporations and tax advisors engaging in these types of transactions. If one corporation is permitted to claim an unwarranted tax benefit that its competitors are reluctant to claim, then, in essence, the corporations (and their advisors) that "play by the rules" are being penalized.

Many prominent professional associations, such as the American Bar Association, the New York State Bar Association, the American Institute of Certified Public Accountants, and the Tax Executives Institute, have voiced their concerns with the growing presence of corporate tax shelters and their potentially harmful effects on the Federal income tax system.

B. Why a Corporate Tax Shelter Problem Exists

Critical to a corporation's decision of whether to enter into a tax shelter arrangement is a comparison of the expected net tax benefits with the expected costs of the arrangement. Such a "cost-benefit" analysis takes into account a corporate participant's economic risks in the event the expected net tax benefits fail to materialize. The imposition of a penalty should be a significant feature of the "cost" side of the equation, and the Joint Committee staff focused on the cost-benefit analysis in determining the effectiveness of the present-law penalty regime.

The Joint Committee staff believes present law does not provide sufficient disincentives to engaging in these types of transactions.[18] The cost-benefit analysis is skewed in favor of investing in corporate tax shelter transactions. There are signifi-

[18] The Joint Committee staff study identified other factors that have contributed to the increasing trend of corporate tax shelter activity. These factors are: (1) the emerging view of a corporate tax department as a profit center; (2) the relatively insufficient risk of penalties or other significant deterrents for entering into such transactions; (3) the role of tax advisor opinions in mitigating any risk of penalties; and (4) the insufficiency of standards of practice and the lack of enforcement of such standards.

cant potential benefits from entering into a corporate tax shelter transaction with little corresponding cost. The chances of a corporation being subject to a penalty from a corporate tax shelter are small. The Joint Committee staff believes that the cost of entering into abusive tax arrangements should be increased to deter this type of activity.[19] The most effective means of realigning the cost-benefit calculus is to clarify and enhance the present-law penalty regime.

C. Clarifying and Enhancing the Present-Law Penalty Regime

Although the present-law penalty regime includes certain specific provisions aimed at corporate tax shelters, the Joint Committee staff believes that the present-law structure is ineffective at deterring inappropriate corporate tax shelter activity. Nevertheless, the present-law penalty regime provides a useful framework from which refinements and improvements can be made. Moreover, because the policy considerations that gave rise to enactment of that framework in the first place (*i.e.*, deterrence of tax shelter activity) is just as true today, the present-law penalty regime appears to be the appropriate starting point in addressing the undesirable corporate shelter activity. The Joint Committee staff recommendations therefore focus on clarifying and enhancing the present law corporate tax shelter penalty regime. A meaningful penalty regime would alter the cost-benefit analysis of corporate participants in a manner that will discourage abusive transactions without interfering with legitimate business activity.

D. Alternative Responses

Maintaining the status quo

Some argue that no legislative response to the corporate tax shelter problem is necessary; the present-law penalty regime would be effective in deterring corporate tax shelter activity if only (1) the Treasury Department would issue long-overdue guidance with respect to the penalty regime, and (2) the IRS would enforce the existing rules. The Joint Committee staff believes the present-law penalty structure contains a number of structural weaknesses that significantly undermine its effectiveness. Some of the weaknesses may be attributable to a lack of statutory guidance with respect to recent legislation regarding corporate tax shelters. For example, the Taxpayer Relief Act of 1997 amended the definition of a corporate tax shelter to cover any entity, plan or arrangement entered into by a corporate participant if a "significant purpose" is the avoidance or evasion of Federal income tax. However, there appears to be much uncertainty, both in the Treasury Department and in the business community, as to what constitutes a "significant purpose" and no guidance has been issued by the Treasury Department. At the same time, the lack of statutory guidance could subject any regulatory guidance to criticism for exercising too much discretion and exceeding statutory authority in resolving these issues.

In addition, it appears that penalties are rarely collected in connection with tax shelters. The lack of imposition of present-law penalties may be, in part, a result of a lack of statutory guidance. For example, the facts and circumstances necessary to satisfy the reasonable cause exception to the substantial understatement penalty attributable to corporate tax shelters[20] is widely disputed. Some tax professionals believe an opinion from a tax advisor is all that is necessary. Others believe that if the test in the regulations were enforced, few taxpayers would ever avoid this penalty. Given the wide range of interpretations, it is not surprising that the IRS generally waives the imposition of this penalty whenever a corporate taxpayer produces a favorable opinion letter from a professional tax advisor.

Another shortcoming of the section 6662 penalty for corporate tax shelters is that the penalty generally applies (in the absence of negligence) only if the understatement of tax is "substantial." For a corporation, an understatement is substantial only if it exceeds 10 percent of the tax that is required to be shown on the return (or if greater, $10,000). A corporation therefore can engage in corporate tax shelter activities knowing that it will not be subject to an understatement penalty provided that the tax benefit does not exceed this 10 percent threshold. For a large corporation, this can represent a significant amount. In addition, the penalty applies only if there is an overall underpayment of income tax for the taxable year, regardless

[19] Corporations do not act alone in designing ways to avoid paying their fair share of taxes. Many other parties act in concert with the corporate taxpayer to facilitate such devices. As a result, the Joint Committee staff study recommends that the stakes (and standards) should be raised for these other participants as well, and disclosure should be required of promoters of corporate tax shelter activity.

[20] Treas. Reg. sec. 1.6664–4(e).

of whether the tax return understates taxable income with respect to a specific transaction. As a result, a taxpayer could use overpayment items to offset the underpayment from a corporate tax shelter and thereby avoid a penalty.

Maintaining the status-quo also results in greater pressure to address each specific tax shelter transaction separately. Although in recent years there has been a flurry of legislative activity aimed at specific corporate tax shelters, such ad-hoc responses, by their very nature, rarely are enacted in a timely manner. These responses typically do not occur until after there has been significant loss in revenue. Also, because legislative changes generally apply on a prospective basis, corporations that engage in this activity early during the "life cycle" of a corporate tax shelter often retain the inappropriate tax savings. When the changes are not entirely prospective, a fairness concern is raised insofar as taxpayers may not have sufficient notice that the legislative changes will have affected their transaction. And as a realistic matter, the government may never become aware of some transactions that would be considered as abusive corporate tax shelters.

Changing the cost-benefit calculus should deter taxpayers from entering into corporate tax shelters. While it is true that the IRS has won several recent tax shelter cases, litigation is an inefficient deterrent (because of the uncertainties of the audit process, the costs and hazards of litigation, delays in resolution, and similar reasons previously discussed), and the status quo does not provide sufficient disincentives for taxpayers to engage in tax shelter transactions.

The problems with the present law penalty regime extend beyond taxpayer sanctions. There is little guidance and enforcement of standards for tax shelter opinions. If an advisor provides an opinion to protect a taxpayer from penalty, there is little or no risk of sanction to the advisor if the opinion is later determined to be improper. The American Bar Association Tax Section recently suggested changes to the standards of practice before the IRS, known as Circular 230, which imposes some standards on tax shelter opinions. These suggestions are a good first step. However, the ABA Tax Section's suggestions are predicated on the present-law "more likely than not" standard, which the Joint Committee staff believes should be raised.[21] The Joint Committee staff study includes recommendations on how the current rules under Circular 230 should be revised to regulate the conduct of practitioners as it relates to corporate tax shelters. Unfortunately, the IRS Director of Practice recently stated that, although the IRS could be proposing changes to Circular 230 next spring, these proposals are unlikely to tackle any "controversial issues" such as modifications to tax shelters.[22] Such a noncommittal response illustrates that Congress should provide the IRS with strong guidance on how to address the tax shelter issue.

A substantive law change

Some believe that clarifying and strengthening the penalty rules would be insufficient unless changes are also made to substantive tax law. The Joint Committee staff believes the substantive rules, including the common law doctrines, provide a sufficient, well-developed body of law for corporations to consider when evaluating tax shelter arrangements. The problem is not that the IRS lacked the necessary tools to challenge the transaction, nor can it be said that each taxpayer was unaware of the common-law doctrines. For example, the courts in each of the cases previously discussed—the *ACM* case, the *Compaq* case, and the *Winn-Dixie* case—relied on well-known, long-standing common-law doctrines to disallow the claimed tax benefits. The problem is that, from an economic (*i.e.*, cost-benefit) perspective, the taxpayer concluded that *it had little (if any) financial risk by going forward with the transaction*. One only needs to look at the imposition of penalties in the cases. Neither the *ACM* case nor the *Winn-Dixie* case makes reference to penalties.[23] In the *Compaq* case, the Tax Court imposed a negligence penalty under section 6662, though the facts are somewhat unusual in that the taxpayer did not seek an opinion of counsel, and the court noted how the corporate officer did little due diligence (and shredded the spreadsheet). In other words, there seems to be sufficient, well-developed case law that is flexible and adaptable to address the substantive issue of

[21] Joint Committee staff study includes a recommendation that would eliminate the substantial understatement penalty attributable to corporate tax shelters only if the corporate participant is "highly confident" (*i.e.*, reasonably believes that there is at least 75-percent chance that the tax treatment would be sustained on the merits). In addition, the Joint Committee staff recommends raising the minimum standards for tax return positions for both taxpayers and tax preparers.

[22] *See* Barton Massey, "Circular 230 Changes Unlikely to Address Shelters or Practice of Law," 1999 *TNT* 206–5, (Doc 1999–34521), October 26, 1999.

[23] The imposition of penalties may be a continuing issue in the *ACM* case.

whether a tax shelter exists. What is lacking is a meaningful penalty structure that would significantly alter the cost-benefit calculus.

Another important concern with enacting a substantive rule is the inherent difficulty of crafting a rule that is sensitive to the tax system's reliance on objective, rule-based criteria while at the same time does not impede legitimate business transactions from going forward. A substantive law change should be precise so as to target abusive transactions but not affect legitimate business transactions. The difficulty lies in crafting a definition of a "tax shelter." There can be significant disputes as to whether a particular transaction is a tax shelter. This is why the Joint Committee staff study identifies certain common characteristics of corporate tax shelter arrangements, referred to as "tax shelter indicators,"[24] which, if present in an arrangement, would result in an understatement penalty only after a determination that the arrangement caused an understatement of the corporate participant's tax liability. Thus, it is not enough that the arrangement appears to be a tax shelter; there must be a determination that the tax treatment was improper *and* the taxpayer must have had less than a high level of confidence that the tax treatment was proper in order for a penalty to be imposed. This relieves much of the pressure of crafting a precise definition of a corporate tax shelter, which would exist if a substantive law change was adopted.

E. Summary

In summary, the cost-benefit analysis should be altered to discourage corporations from entering into abusive transactions without affecting legitimate business transactions. An enhanced penalty structure with more detailed disclosure requirements and more stringent standards for other participants in the corporate tax shelter would strike the appropriate balance and alter the cost-benefit analysis in a manner that would provide a sufficient deterrent effect.

IV. Specific Recommendations

Consistent with its analysis and conclusions, the Joint Committee staff recommends the following with respect to corporate tax shelters.

Recommendations that affect corporations which participate in corporate tax shelters

A. Clarify the definition of a corporate tax shelter for purposes of the understatement penalty with the addition of several "tax shelter indicators." This recommendation builds on the present-law definition of a corporate tax shelter found in section 6662 (the accuracy related penalty). Under that definition, a tax shelter exists if a significant purpose of a partnership, or other entity, plan, or arrangement is the avoidance or evasion of Federal income tax. The recommendation expounds upon that definition by providing certain "indicators" that if present will cause a partnership, or other entity, plan or arrangement in which a corporation is a participant to be considered to have a significant purpose of avoidance or evasion of Federal income tax.

The indicators were developed from what we found to be common characteristics of corporate tax shelters. At the same time, so as to ensure that there will be no interruption to legitimate business activity, the list excludes many common characteristics and is narrowly tailored to avoid any overreaching. Most importantly, the indicators themselves do not cause a penalty to be created. The penalty is imposed only if an understatement exists—meaning that a determination has been made (for example, by losing in court) that the tax benefits related to a transaction were improper an not permitted under present law. The indicators are:

(1) The reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected net tax benefits.
(2) The arrangement involves a tax-indifferent participant, and the arrangement (1) results in taxable income materially in excess of economic income to the tax-indifferent participant, (2) permits a corporate participant to

[24] The Joint Committee staff study identified five common characteristics of modern corporate tax shelter transactions. These characteristics are: (1) an arrangement in which the reasonably expected pre-tax profit is insignificant when compared with the expected tax benefits; (2) the involvement of a tax-indifferent participant; (3) the use of guarantees, tax indemnities and similar arrangements, including contingent fee structures; (4) a difference between tax reporting and financial statement reporting, especially where permanent differences arise; and (5) the lack of any appreciable change in economic position, particularly when a corporation does not take on any additional economic risk. Any corporate transaction which exhibits one of these characteristics (";tax shelter indicator") should be considered to have a significant purpose of avoiding or evading Federal income tax for purposes of an understatement penalty.

characterize items of income, gain, loss, deductions, or credits in a more favorable manner than it otherwise could without the involvement of the tax-indifferent participant, or (3) results in a noneconomic increase, creation, multiplication, or shifting of basis for the benefit of the corporate participant, and results in the recognition of income or gain that is not subject to Federal income tax because the tax consequences are borne by the tax-indifferent participant.

(3) The reasonably expected net tax benefits from the arrangement are significant, and the arrangement involves a tax indemnity or similar agreement for the benefit of the corporate participant other than a customary indemnity agreement in an acquisition or other business transaction entered into with a principal in the transaction.

(4) The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is reasonably expected to create a "permanent difference" for U.S. financial reporting purposes under generally accepted accounting principles.

(5) The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is designed so that the corporate participant incurs little (if any) additional economic risk as a result of entering into the arrangement.

B. An entity, plan, or arrangement can still be a tax shelter even though it does not display any of the tax shelter indicators, provided that a significant purpose is the avoidance or evasion of Federal income tax.

C. Modify the penalty so that, with respect to a corporate tax shelter, there would be no requirement that the understatement be substantial.

D. Increase the understatement penalty rate from 20 percent to 40 percent for any understatement that is attributable to a corporate tax shelter. The IRS would not have the discretion to waive the understatement penalty in settlement negotiations or otherwise for corporate tax shelters.

E. Provide that the 40-percent penalty could be completely abated (*i.e.*, no penalty would apply) if the corporate taxpayer establishes that it satisfies certain abatement requirements. Foremost among the abatement requirements is that the corporate participant believes there is at least a 75-percent likelihood that the tax treatment would be sustained on the merits. Another requirement for complete abatement involves disclosure of certain information that is certified by the chief financial officer or another senior corporate officer with knowledge of the facts.

F. Provide that the 40-percent penalty would be reduced to 20 percent if certain required disclosures are made, provided that the understatement is attributable to a position with respect to the tax shelter for which the corporate participant has substantial authority in support of such position.

G. Require a corporate participant that must pay an understatement penalty of at least $1 million in connection with a corporate tax shelter to disclose such fact to its shareholders. The disclosure would include the amount of the penalty and the factual setting under which the penalty was imposed.

Recommendations that affect other parties involved in corporate tax shelters

A. Increase the penalty for aiding and abetting with respect to an understatement of a corporate tax liability attributable to a corporate tax shelter from $10,000 to the greater of $100,000 or one-half the fees related to the transaction.

B. Expand the scope of the aiding and abetting penalty to apply to any person who assists or advises with respect to the creation, implementation, or reporting of a corporate tax shelter that results in an understatement penalty if (1) the person knew or had reason to believe that the corporate tax shelter could result in an understatement of tax, (2) the person opined or advised the corporate participant that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged, and (3) a reasonable tax practitioner would not have believed that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged.

C. Require the publication of the names of any person penalized under the aiding and abetting provision and an automatic referral of the person to the IRS Director of Practice.

D. Clarify the U.S. government's authority to bring injunctive actions against persons who promote or aid and abet in connection with corporate tax shelters.

E. Include the explicit statutory authorization for Circular 230 in Title 26 of the United States Code and authorize the imposition of monetary sanctions.

F. Recommend that, with respect to corporate tax shelters, Treasury amend Circular 230 generally to (1) revise its definitions, (2) expand its scope, and (3) provide more meaningful enforcement measures (such as the imposition of monetary sanc-

tions, automatic referral to the Director of Practice upon the imposition of any practitioner penalty, publication of the names of practitioners that receive letters of reprimand, and automatic notification to state licensing authorities of any disciplinary actions taken by the Director of Practice).

DISCLOSURE AND REGISTRATION OBLIGATIONS

A. Corporate taxpayer disclosure

(1) *30-day disclosure.*—Arrangements that are described by a tax shelter indicator and in which the expected net tax benefits are at least $1 million would be required to satisfy certain disclosure requirements within 30-days of entering into the arrangement.

- The 30-day disclosure would include a summary of the relevant facts and assumptions, the expected net tax benefits, each tax shelter indicator that describes the arrangement, the analysis and legal rationale, the business purpose, and the existence of any contingent fee arrangements.
- The chief financial officer or another senior corporate officer with knowledge of the facts would be required to certify, under penalties of perjury, that the disclosure statements are true, accurate, and complete.

(2) *Tax-return disclosure.*—Arrangements that are described by a tax shelter indicator (regardless of the amount of net tax benefits) would be required to satisfy certain tax-return disclosure requirements.

- The tax-return disclosure would include a copy of any required 30-day disclosure.
- The tax-return disclosure also would identify which tax shelter indicators describe one or more arrangements reflected on the return.

B. Tax shelter registration

(1) Modify the present-law rules regarding the registration of corporate tax shelters by (1) deleting the confidentiality requirement, (2) increasing the fee threshold from $100,000 to $1 million, and (3) expanding the scope of the registration requirement to cover any corporate tax shelter that is reasonably expected to be presented to more than one participant.

(1) Require additional information reporting with respect to the registration of tax shelter arrangements that are described by a tax shelter indicator. The additional information would include the claimed tax treatment and summary of authorities, the tax shelter indicator(s) that describes the arrangement, and certain calculations relating to the arrangement.

V. CONCLUSION

The Joint Committee staff believes that a corporate tax shelter problem exists, and the problem is becoming widespread and significant. The Joint Committee staff further believes that increasing the penalties for engaging in corporate tax shelters would sufficiently alter the cost-benefit analysis with respect to engaging in such transactions and would provide a measured response to the corporate tax shelter problem. The Joint Committee staff's analysis and specific recommendations are discussed in more detail in the Joint Committee staff study.

I thank the Committee for the opportunity to present the Joint Committee staff recommendations on corporate tax shelters, and I would be happy to answer any questions the Committee may have at this time and in the future.

[Attachments are being retained in the Committee files.]

Mr. HOUGHTON. Mr. Hulshof.

Mr. HULSHOF. Thanks, Mr. Chairman.

Mr. Talisman, does the Treasury Department endorse Mr. Doggett's bill in its current form?

Mr. TALISMAN. There are a number of similarities between Mr. Doggett's bill and our bill, including codification of the economic substance doctrine, increasing disclosure and increasing the substantial understatement penalty. We agree with that approach. We obviously had a slightly different manner of codifying the economic

substance doctrine and would be happy to work with Mr. Doggett and the rest of the tax writing staff as we do in crafting the correct language to codify the economic substance.

Mr. HULSHOF. So the answer is yes and no.

Mr. TALISMAN. I think it is largely yes.

Mr. HULSHOF. In a letter that the Treasury wrote, I think maybe you penned to Mr. Doggett, you indicated that it was the Treasury's belief that his bill would not—and I am paraphrasing—would not unduly interfere with legitimate business transactions. Should we be considering anything that interferes at all with legitimate business transactions?

Mr. TALISMAN. Well, in order to identify corporate tax shelters, the disclosure provisions will be crafted in a way that uses particular filters to ensure that the transactions are disclosed. Some transactions that will be disclosed will be legitimate business transactions. At that point the Service will apply the economic substance doctrine in a manner that would not, we believe, either unduly or duly affect legitimate business transactions because it is merely—again, our approach and Mr. Doggett's approach are merely codifications of the current economic substance doctrine which already applies.

Mr. HULSHOF. Again, I guess what I think we have to guard against, we, all of us, is legislating based on hyperbole or legislating based on the bad case. My law school tax professor told me that bad cases make bad law. And it is one thing for us on this side to rail against $450 bottles of cabernet and whether the meal allowance deduction is proper, when, in fact, information from the Treasury Department, as Mr. McCrery pointed out yesterday, is that the average business meal costs $11.61.

So the other thing I wanted to ask you about is do you believe right now that Treasury has insufficient antiabuse tools available? And while you are munching on that, let me just specifically point out—and I wasn't here in 1995, but this Committee talked about and proposed requiring registration of corporate tax shelters. That was included in the measure that the President eventually vetoed. But finally, I think, in the Treasury's green book that accompanied the President's fiscal year budget for fiscal year 1997 said that requiring registration of corporate tax shelters would be something very useful. So as a result of that, this Committee and the House and Senate included that. It was signed into law by the President on August 5th of 1997.

So, here's something that Treasury requested, Congress acted, in an effort to crack down on these illegitimate corporate tax shelters, and yet Treasury has, to my knowledge, as yet to issue any guidance necessary to make that those rules take effect. Is that the present state of affairs?

Mr. TALISMAN. That is correct. However, that legislation had as part of the registration requirements three conditions for registration, one of which was issuance under conditions of confidentiality. It is our understanding that the tax shelter promoters are now not relying on conditions of confidentiality in large part because of the potential application of those rules, and that they are relying more on tacit understandings or other agreements to maintain the confidentiality of the regs.

Also, given that we were requesting additional guidance with respect to the definition of corporate tax shelter, the current definition actually in that legislation is a significant purpose of tax avoidance, which is a very broad standard and actually has been interpreted by some to include all business transactions. We were concerned about, when we were looking for a narrower approach, codifying the economic substance doctrine to issue guidance that would either have been considered too broad or too narrow depending on one's view, and that when we were coming to Congress looking for additional tools to attack corporate tax shelters, to come out with guidance that might set us back.

Obviously we are looking at—certainly in the context of looking at the prospect for legislation. We will review that decision in the upcoming months.

Mr. HULSHOF. I would ask the Chairman to indulge me just as a final comment, and, Ms. Paull, I didn't have a chance to inquire, but you mentioned beefing up the penalty scheme, which, again, this Committee did in 1997 in a couple of different areas. You mentioned the specific cases by name that I think clearly those that are interested, of course, read those opinions very carefully in determining how aggressive they want to be in marketing these types of shelters. I would suggest to you Circular 230, which would be another vehicle that Treasury could use to help implement and guide those practitioners.

I mean, we all want to get to the same place. And I guess the question that I am asking myself is do we need to go further than—and we want to provide you the tools available, but the tools we provided, I am not sure they have been aggressively used in an effort to crack down. So I appreciate your work on this, and, Ms. Paull, yours as well.

With that, I see my time has expired. I would yield back. Thank you.

Mr. HOUGHTON. Thank you very much.

Mr. Doggett.

Mr. DOGGETT. Thank you, Mr. Chairman.

Ms. Paull, I am sure that the additional materials you submitted will be useful and that I will learn from them. I would like to focus on those that you filed back in July, the report and your oral comments, because I find a number of areas of agreement. First you indicate today that this is not only a serious problem, but it is a growing problem as you see it and as your staff there on the Committee sees it.

Ms. PAULL. That is correct.

Mr. DOGGETT. I believe you indicated in the July 22nd report that the—to use your words—that this corporate tax shelter phenomenon poses a serious challenge to the efficacy of our entire tax system.

Ms. PAULL. That is correct. I believe the Treasury Department reiterated that today.

Mr. DOGGETT. And given the very serious nature of this problem, though you and I may have slightly different ways of trying to get at the problem, wouldn't you agree that it would be a very serious mistake for this Congress not to address legislatively the shelter hustlers?

Ms. PAULL. This Congress? You are not suggesting today, right?

Mr. DOGGETT. I don't mean tomorrow or Saturday, but during the course of this particular Congress, perhaps the second session.

Ms. PAULL. I do believe that it is urgent. I also would have to acknowledge that it is a very complicated issue, and that we hope that this appendix will help you focus on the kinds of issues that we and others have identified.

Mr. DOGGETT. I sure agree with you on that.

And as far as the remedies that you have advocated, one of them is, I believe, on page 9 of your July 22nd report, disclosure obligations. And there are some additional disclosures that you think would be appropriate for corporate tax shelters. I am not going to go through them line by line, but the idea of some additional disclosure, somewhat different perhaps than that that I provide in HR 2255, you think would be helpful?

Ms. PAULL. I do think disclosure would be helpful, but I don't think it is a panacea.

Mr. DOGGETT. I concur with you on both.

Is it your belief that it is possible to have some additional disclosure requirements that will neither unduly nor duly interfere with the operation of legitimate business?

Ms. PAULL. I do think it would be useful for some additional disclosure. I think you have to be realistic about the disclosure, though, because certainly if you are going to take the approach of your bill or the Treasury approach where you have put a cloud over a variety of transactions, and then you ask people to come forward and self-confess to those transactions, it is a lot more difficult to get that kind of disclosure. On the other hand I can see a tremendous benefit if we could get some early warning disclosure for aggressive transactions somehow. And so there is a tension there between the kinds of proposals that you move forward.

Mr. DOGGETT. You certainly would disagree with someone who would come forward and say it is a myth that we can't have reasonable disclosure requirements to deal with this problem?

Ms. PAULL. I think you can have reasonable disclosure requirements.

Mr. DOGGETT. Then with reference to the penalty provisions, although we address it in a slightly different way, you and I agree that we need to have heightened penalties.

Ms. PAULL. Correct.

Mr. DOGGETT. That is the principal focus of the joint tax report, I believe.

Ms. PAULL. That is correct.

Mr. DOGGETT. I believe we also—though we deal with it in a slightly different way, we also agree that there is a problem with the opinion letter, what I call the excuse letter, that happens at present, and that, again, you think you can heighten the standard for it, but that it is not satisfactory to leave the law as it is now with reference to these opinion letters that perhaps the same tax hustler that provided the tax shelter recommends the law firm that is going to say it is okay.

Ms. PAULL. We feel strongly that the standards for preparing opinion letters should be elevated, and let me just point out we also feel strongly that with respect to other kinds of penalties outside

of the corporate tax shelter area, that the standards filing tax returns and getting out of penalties ought to be elevated as well. And that is also covered in our study, but not the subject of this hearing, because it is a corporate tax shelter hearing.

Mr. DOGGETT. With regard to this tension between trying to have enough certainty for a taxpayer to be able to rely and comply versus not providing a road map for hustlers to avoid the law, you have used in some of your recommendations terms that aren't all that different from ″substantial″ and ″meaningful″ in different contexts, haven't you?

Ms. PAULL. This is the most difficult thing to deal with is how you define the corporate tax shelter. For our recommendations, we defined it for purposes of determining a penalty after you have applied the common law doctrines and you found an understatement of tax.

Mr. DOGGETT. You are aware that one of our later witnesses Mr. Hariton thinks your definitions are more vague than he thinks my definitions are vague.

Ms. PAULL. Well, this is one of the most difficult parts of this exercise.

Mr. DOGGETT. Mr. Chairman, I have got other questions for Mr. Talisman, but perhaps after some other witnesses.

Mr. HOUGHTON. Okay. Thanks very much.

Mr. Tanner.

Mr. TANNER. Thank you, Mr. Chairman.

I would like to follow up. I am sorry I was late, but your testimony, I have heard, has been enlightening from the standpoint that all of us desire a clear—as clear a standard as we can have, both from the practitioner standpoint as well as the company as well as our standpoint and, I assume, yours.

And the, I think, common concern shared by all who approach this problem is to what extent this bill or these proposals impede unnecessarily on the legitimate pursuit of prudent business practices as it relates to the Tax Code as it may be written now or in the future.

Is it your position that—let me back up. I realize, as you said, this is a—there is no easy definition, and it is probably a moving target as innovations take place, as they normally do in the marketplace of ideas, which makes it more—all the more complicated. What I guess my question is to what extent have you thought about the proposals impacting negatively on legitimate transactions when there is this acknowledged vagueness as it relates to the standard? Could you finish your comment that you were making to Mr. Doggett on that, please?

Ms. PAULL. Sure. Well, as I said, it is very difficult to define or corporate tax shelter. Mr. Doggett's testimony quoted Michael Graetz from Yale, defining it to be a deal done by very smart people that, absent tax considerations, would be very stupid. Now, that is a nice way to look at it, but you—when you are crafting rules of law, you need to have rules of law that are susceptible to some interpretation. I think this is really where you have a tension. Do you attempt to codify a very flexible set of court-made law into the Code? We come down against that. Mr. Doggett and the Treasury Department come down in favor of it. And I would just have to say

Mr. Doggett's formulation of those standards is elevated over the common law, court-made law.

Mr. TANNER. So you say the threat——

Ms. PAULL. That is where you get into the legitimate business transactions. Transactions that might pass muster today under court-made law will have more difficulty passing muster under Mr. Doggett's standard, I would just point that out. That is one of the principal reasons why our estimate of Mr. Doggett's bill is higher than the Treasury proposal. Mr. Doggett's bill goes further and also picks up individuals. There are another smaller factors as well.

I hope that is somewhat responsive. If you are going to try to codify the common law, then you must rely on things like what Mr. Doggett does and the Treasury Department does in terms of exemptions from it. You have got to go down that road, and that becomes very political. You must develop list of good things.

I do have a series of common business transactions I could go over with you to show, they don't pass muster under the basic tests under these bills. Then you have to rely on the Treasury Department adding to Mr. Doggett's list of good transactions, or getting out under this very vague standard of "clearly contemplated by the law." What does that mean? Because I will tell you, we went back and looked at the low-income housing tax credit. That is intended for people to make an investment that they would not otherwise make. The tax breaks make that an economic investment for the most part. When you look at the written legislative history behind that tax credit, you can't find that notion in there. So does that mean it wasn't clearly contemplated by the law that this tax credit is going to make up the difference to make it an economic investment? This is really a difficult area that the Committee is going to have to grapple with.

Mr. TANNER. Do you have a comment?

Mr. TALISMAN. Yes. I believe, first of all, from our standpoint codification of the economic substance doctrine is necessary because it ensures the taxpayers are applying the right economic substance doctrine at a level that is appropriate to these transactions. We obviously would build in mechanisms to protect against inappropriate application of the doctrine.

As I talked about, an expedited ruling process, the centralization of the IRS review process and coordination at the national office would all protect against application to transactions that are legitimate ordinary-course-of-business transactions. But companies need to be discouraged from engaging in engineered transactions that have no relation to their core business.

And so we think that the codification of that doctrine will ensure that they will apply it to each transaction before the fact rather than after the fact and wait for judge-made law many years after the fact to shut down these transactions, and that is our concern.

I also think that it is appropriate to point out that the recent cases have used the standard comparison of pretax profit to the expected tax benefits, which is the standard we are applying. And the ABA has a similar approach in their testimony where they say any time the economic substance doctrine would apply, you would use effectively the standard, which is the—what we think is sort of the articulation of the best of the case law.

Mr. TANNER. Well, I have another, but I see my time has expired, Mr. Chairman, and I am very aware of the Chairman's appreciation of time. So I will yield back.

Mr. HOUGHTON. Okay. Thanks very much.

Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman.

Ms. Paull, Mr. Talisman, let me ask you a question with regard to what Treasury has currently in place. It seems at this point the testimony we have heard speaks to the issue of tax shelters and the need to perhaps increase penalties. There seems to be full agreement on that. There seems to be disagreement on how far you need to go beyond beefing up penalties and the like.

Let me ask you about your particular shop within Treasury. To what degree could this whole issue—and if you want to define it as a problem—this whole issue or problem be addressed simply through more aggressive enforcement by IRS of these concerns with tax shelters?

Mr. TALISMAN. Well, again, I think aggressive enforcement is certainly an appropriate response to these shelter activities. I don't think it is a panacea to the problem. We have already, as we have discussed, one case recently in the Tax Court and cases elsewhere applying the economic substance doctrine to cases. However those cases occurred in the 1990s, early 1990s, and promoters and participants have moved on to other transactions which arguably do not meet the facts of the cases to which the taxpayers lost previously.

We also have aggressively sought legislation to shut down shelters of which we are aware and also, when appropriate, used our authority to address specific shelters either by ruling or regulation. Recently we issued a regulation dealing with the so-called Chutzpah Trust, son of Accelerated Charitable Remainder Trust. In 1997, Congress passed legislation shutting down accelerated—abuse of uses of accelerated charitable remainder trusts, and so this was a similar device. So it shows that taxpayers are willing to move on to the next product whenever they can.

Mr. BECERRA. If you were to try to enhance your enforcement activity or accelerate it, would one of the net results be you would end up being more intrusive, you would have to engage in more intrusive behavior to try to ferret out any abusive activity in tax shelter activities that occur?

Mr. TALISMAN. I believe that identification, up front identification of these transactions is important, and certainly something that I believe all the parties, certainly the joint Committee, Mr. Doggett, and us have all proposed. We hope that will help limit the intrusion. And frankly, one of the reasons we came forward—and we actually have modified our original proposal to provide objective filters, more objective filters based on the characteristics of corporate tax shelters that we have identified to try and limit the intrusiveness, to focus on those transaction most likely to be tax-engineered abusive transactions.

Mr. BECERRA. Ms. Paull, if we were to not take any action in the near term and rely only on what we have in place, if we were to try to have greater success in trying to diminish the use of these shelters, would it not lead us to having to go towards more aggres-

sive enforcement and, based on what Mr. Talisman has said, probably more intrusive behavior in trying to reduce the amount of tax shelter abuse that might occur?

Ms. PAULL. Well, certainly one would hope the IRS would be prioritizing the corporate tax shelter items at this point in time after all that has been said before Congress this year. So that is number one. I mean, clearly enforcement is an issue, and the IRS ought to be going after these transactions. I think you will be faced, no matter what you do here, with transactions in the future that you will review and have to legislate on, just like you have done in the past. I don't think that whatever you do here will avoid that kind of thing.

Mr. BECERRA. But short of providing yourself with additional tools to try to go at this problem, you probably have to be more aggressive with the tools you have in place.

Ms. PAULL. As I said in my testimony, we really think the penalty regime is flawed and should be beefed up considerably. We think disclosure would be helpful, but we ought to be realistic about what you can get in a disclosure regime.

Mr. BECERRA. Thank you.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Talisman, before we release you, as it were, today, and Mrs. Paull also, I hope this question has not been asked. If it has, you can briefly respond. Are you satisfied that you and the IRS are aggressively implementing all of the powers that the Congress has already given you in this field?

Mr. TALISMAN. Mr. Chairman, we are certainly working with the IRS to aggressively pursue this issue with all available opportunities. I previously spoke to the issue of the 6111 registration requirements, which may be the basis for your question. We were concerned about issuing those regulations at a time when we were seeking additional powers, given the broad standard that was present in those regulations, a significant purpose of tax avoidance. We also understand from the marketplace that one of the requirements for application of those registration requirements, conditions of confidentiality, is basically now not a condition of these corporate tax shelters; therefore, we do not expect by issuing the regulation that we would get very many registrations. And so we wanted to wait and see what the Congress—and listen to the testimony and the comments based on the White Paper to make sure that we were properly structuring any response in this area.

Chairman ARCHER. Well, the Congress has given you fairly broad powers to get at this problem. If you feel that there is still a big problem, why would you not take advantage of all of these powers so that we could get the benefit of what the results might be before we contemplate doing something else?

Mr. TALISMAN. I believe the Treasury Department has been very aggressive in pursuing the corporate tax shelters of which we are aware. And we have exercised our anti-abuse authority in appropriate circumstances to the extent it is applicable. For example, we just exercised our anti abuse authority under section 643 dealing with the son of Accelerated Charitable Remainder Trust, or so-called Chutzpah Trust. Commissioner Rossotti has just announced an initiative to go and pursue, again aggressively, corporate tax

shelters of which we are aware. The IRS has won a series of cases recently that demonstrate that they were aggressively pursuing corporate tax shelters that arose on audit, but most of those cases arose in the early 1990s. So the effect of those cases, those transactions, are largely—have largely vanished from the marketplace, and we are onto new and different tax shelters.

So our problem is we are always playing a game of catch up. While we can use our anti-abuse authority and our specific authority to address particular shelters as they come—as we become aware, the problem is that we are not aware of all the shelters, and what we need to do is change the dynamics so that taxpayers apply an appropriate cost-benefit analysis and don't engage in artificial tax-engineered transactions before the fact rather than after the fact.

Chairman ARCHER. Ms. Paull, do you agree with that? Does the joint Committee analysis show that the Treasury is effectively and aggressively using all of the powers which have already been granted to them by the Congress?

Ms. PAULL. Well, I would have to say that we have done a survey, in essence, through conversations with the IRS and the Treasury Department on what they are doing. I think that, like anything, you can do more. I think enforcement ought to be a high priority within the Service. And as far as we know, that is what the Commissioner has committed to recently.

Chairman ARCHER. But that commitment—I don't want to read between the lines, and I want to get this direct. If I read between the lines, I would infer from what you said that that has not yet been fully implemented to where we can see the effectiveness of it and make a judgment. The commitment may be there, but has the actual implementation to fulfill that commitment occurred so that we have empirical data to make a judgment on how effective it is?

Ms. PAULL. Right. We have been inquiring within the IRS, and we along with the Treasury Department hope that we are going to get more data from them on what enforcement activities they have been undergoing. My testimony includes some data relating to specific cases the IRS recently won. We have preliminary data on that, and we know there are some other big transactions in the pipeline.

I think that this is just the kind of thing that there is always going to be a time lag in trying to evaluate how effective the enforcement is. But I would agree with Mr. Talisman that the current law on corporate tax shelters, both registration requirements and the penalty regime, is not effective and needs to be worked on.

Chairman ARCHER. Okay. But the penalties are independent of whether or not there is an abuse. Those are what would be levied in the event that there is an abuse found. They do not set the criteria for the abuse.

Ms. PAULL. That is correct. But you do have to come up with some sort of definition of an abusive transaction that would be hit, if you wanted to elevate and strengthen the penalty.

Chairman ARCHER. That leads me to another question for Mr. Talisman which relates to the inquiry that he made of Mr. Doggett. I am concerned about shifting the burden of proof onto the taxpayers because we are trying to work away from that in tax reform. And where it says in the bill that every deduction or loss or

credit under the tax law will be denied unless the taxpayer can prove that it meets whatever the tests are, which I think may be a little vaguer than what we ought to be having in the law, that is my own personal opinion, but to just speak to what is in the bill denies every deduction loss or credit under the tax law unless the taxpayer can prove that it meets the tests under the bill.

Does the Treasury think in today's time when we are trying to shift the burden back to the government that that is an appropriate way to address this problem?

Mr. TALISMAN. Mr. Chairman, in our legislation what we did was codify what we believe is the best of the economic substance doctrine. And in response to comments we got with respect to our original proposals where we said that the Secretary has authority to deny benefits based on an application of the economic substance doctrine, people were concerned that that would give undue discretion to the Secretary's determination. So when we issued the White Paper, we actually removed the Secretary having authority to deny and made it a level playing field in that with the taxpayer it would be a court review of whether the pretax benefits were significant relative to the tax benefits and the pretax profits are insignificant relative to the tax benefits, and that we believe that that would put an even balance certainly with respect to our application.

Chairman ARCHER. So let me be sure I understand your answer. Your answer, as I understand it, is that it would not be wise to adopt the terminology in this bill that a taxpayer could only get a deduction loss or credit if they proved that they had met certain tests; is that a fair analysis of your statement, that you do not agree with that approach that is in this bill?

Mr. TALISMAN. I believe that we have to put in place appropriate protections for legitimate business transactions, and one aspect of that would be looking at the burden of proof issue.

Chairman ARCHER. Okay. So does that mean that you do not agree with the approach that is in this bill?

Mr. TALISMAN. As I have commented before, I think we agree largely with the approach in Mr. Doggett's bill.

Chairman ARCHER. This particular aspect of the bill. I can't accept your answer other than to also say you are not categorically in support of this approach, you have a different approach; therefore ,you do not support the approach that is in this bill. Why is it to so difficult to say that?

Mr. TALISMAN. I believe that I am comfortable with our approach.

Chairman ARCHER. You do not support the approach that is in this bill. You believe there is another approach that would be better?

Mr. TALISMAN. Which is our approach, yes, sir.

Chairman ARCHER. So you do not support the approach that is in this bill. Thank you.

Mr. DOGGETT. Mr. Chairman.

Chairman ARCHER. Mr. Doggett.

Mr. DOGGETT. I have not yet inquired of Mr. Talisman, if I could pick up where you left off.

Chairman ARCHER. You are recognized to inquire.

Mr. DOGGETT. Thank you.

With reference to the burden of proof and the provisions of HR 2255, which I know you and your staff have looked at, is it your understanding that this bill doesn't establish a burden of proof independent of however the burden of proof applies in other IRS cases?

Mr. TALISMAN. I believe that is correct.

Mr. DOGGETT. And that the criticism that the Joint Tax Committee had that has been now twisted and directed not by the Chairman, but by a lobby group against my bill, was with reference to the so-called super 269 provision that was going to allow an administrative determination, which did raise a burden of proof problem?

Mr. TALISMAN. That is also correct.

Mr. DOGGETT. And with reference to the letter that you sent to me, my colleague Mr. Hulshof dealt with this earlier, but I want to focus attention on it because it bothered me also. You indicated in the letter that because my bill and your earlier recommendation was targeted toward transactions with little or no economic substance, that it did not unduly interfere with legitimate business transactions. My objective is not to either duly or unduly interfere with legitimate business transactions, and I wonder if you might amplify on that sentence.

Mr. TALISMAN. It may have been a poor choice of words in my letter, but what we were trying to articulate was that our and your disclosure provisions might require legitimate transactions to be disclosed. However, because what we are both doing is codifying the existing economic substance doctrine, we don't believe that that aspect of the provision, of either provision, would interfere with legitimate business transactions.

Mr. DOGGETT. Is it your belief that simply changing or heightening the penalty alone as recommended by Joint Tax will not be sufficient to resolve this problem and keep tax hustlers from doing what they have been doing and are doing today?

Mr. TALISMAN. I do not believe so. And, in fact, I think, as the joint Committee has stated, the penalties are a very critical element of this. But there are two reasons why under current law the penalties are not being applied. One is the reasonable cause exception, which the joint Committee and others have suggested be made stronger. The second reason is you have to first have a substantial understatement to be subject to the penalty, and if you are not applying the economic substance doctrine up front, you may not believe you have a substantial understatement and therefore may not believe you are subject to penalty.

Mr. DOGGETT. Is it also your belief that with reference to the administrative authority that you currently have, that whether you are talking about that which you have already utilized, as you have described it today, or that which you have not yet utilized because of one reason or another, that the existing administrative authority is not sufficiently broad to resolve promptly this problem of abusive corporate tax shelters?

Mr. TALISMAN. We would not be before the Committee today if we did not believe that.

Mr. DOGGETT. Lastly I have used terms in my testimony here and on other occasions such as tax cheat, hustler, sleazy, back

door, black box, underhanded. What I want to ask you is in your experience at the Department, have you seen transactions that you think that those words are fairly applied to with reference to abusive corporate tax shelters?

Mr. TALISMAN. I believe there are artificial abusive tax-engineered transactions that we see at our Department.

Mr. DOGGETT. Thank you very much.

Thank you, Mr. Chairman.

Chairman ARCHER. Are there any other questions for this panel? If not, thank you very much.

Our next panel is Mr. Paul Sax, who is the chairman of the Section of Taxation, American Bar Association; David Lifson, American Institute of Certified Public Accountants; Charles Shewbridge, chief tax executive for BellSouth; and Harold Handler, chair of the New York State Bar Association. If you gentlemen would come to the witness table we will be prepared to receive your testimony.

Welcome. Mr. Sax, would you lead off? And if each of you at the beginning of your testimony would identify yourselves and whom you represent for the record, you may proceed.

Chairman ARCHER. Mr. Sax.

STATEMENT OF PAUL J. SAX, CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, AND PARTNER, ORRICK, HERRINGTON & SUTCLIFFE, SAN FRANCISCO, CALIFORNIA

Mr. SAX. Good morning, Mr. Chairman.

Chairman ARCHER. As usual, without objection, your entire written statement will be inserted in the record, and we would encourage you to summarize in your verbal statement.

Mr. SAX. Thank you, Mr. Chairman.

Good morning, Mr. Chairman and members of the Committee. My name is Paul Sax. I am a partner in the law firm of Orrick, Harrington and Sutcliffe in San Francisco and currently serve as chair of the Section of Taxation of the American Bar Association. Thank you for the opportunity to testify today. Last spring my predecessor Stefan Tucker presented testimony before this Committee's Subcommittee on Oversight and the Senate Finance Committee on corporate tax shelters. My testimony today is consistent. Our message is the same. The Tax Section views itself as counsel to the tax system, and this generation of corporate tax shelters seriously threatens that system.

Certainly revenue loss is a major issue, but perhaps more important is the potential for lost confidence in the tax system. We believe that if you do not act now, when the taxpaying citizenry learns what large corporations were allowed to do, it will be portrayed as a corporate raid on the Treasury, and that will have a seriously detrimental effect on the willingness of individuals to pay their taxes.

The reason this large corporate shelter activity is so threatening is that the promoters are selling a new product. That product is well-calculated defiance of the tax collector. The promoters explain that the chance of audit detection and successful challenge is minuscule; the penalties are small and usually avoidable. The resulting arithmetic of the odds favoring a multimillion-dollar tax saving is simply compelling. Whether the deal would withstand scrutiny is

not relevant. Recent judicial decisions do not materially change these odds. The game has become catch me if you can.

Why have we heard so little about this? A veil of what-is-the-problem nonchalance is a very sophisticated defense. The press are frustrated by claims of confidentiality. This activity is too new to be seen in tax return data. The fall-off in corporate tax revenue quite possibly could have any number of explanations, and the usual defenders of the tax system, the big five and some large law firms, are among the principal promoters. This year end season is worth millions, even billions, to them.

Lawyers have been a part of that problem. We have now addressed that. Less than 2 weeks ago we proposed regulations under Circular 230 that would outlaw the practice of giving penalty protection tax opinions based on hypothetical or false facts. A copy of that submission is attached to our testimony. We submit to you today our legislative proposal. The key to our proposal is disclosure.

Large tax shelters, we use 10 million, must disclose the facts and the basis for their tax saving. Failure to disclose would be backed by a new penalty based solely on failure to disclose. Because the only consequence to legitimate transactions would be disclosure, the effect to legitimate business would be minimal. After all, there is no right to hide facts from the tax collector. A key provision would elevate the visibility within the company, requiring the chief financial officer to attest to the facts. This would preclude the practice of circumventing the tax director who signs the tax return. The existing understatement penalty would be extended to the aider and abettor circle, the promoters, tax and different parties and the tax professionals. Last, the economic substance test now applied by the courts would be codified so that promoters could not contrive ambiguity in the sales effort. Nontax benefits would have to be substantial relative to tax benefits.

Mr. Chairman, if you do this, we believe the current threat to the tax system will be averted. If you do not, we fear the reaction of individual taxpayers when they later learn what was allowed to happen.

Thank you again. That concludes my remarks. As counsel to the tax system, we would be pleased to help. Do not hesitate to call upon us. I would be pleased to respond to your questions.

Chairman ARCHER. Thank you, Mr. Sax.

[The prepared statement and attachment follow:]

Statement of Paul J. Sax, Chair, Section of Taxation, American Bar Association and Partner, Orrick, Herrington, Sutcliffe, San Francisco, California

My name is Paul J. Sax. I appear before you today in my capacity as Chair of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation. It has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

The Section of Taxation appreciates the opportunity to appear before the Committee today to discuss the very important subject of corporate tax shelters.[1] Our testimony will use the term "corporate tax shelters" in discussing the very aggres-

[1] The Section of Taxation has testified regarding corporate tax shelters on two prior occasions this year. On March 10, 1999, the Section testified before the Subcommittee on Oversight, and on April 27, 1999, the Section testified before the Senate Finance Committee. Our testimony today is consistent with this prior testimony.

sive tax transactions currently being marketed.[2] However, the Committee should understand that this phenomenon is not limited to large, multinational corporate taxpayers; indeed, it is not limited to corporations. Increasingly, tax shelter products are also being marketed to unincorporated business taxpayers, including middle market businesses, and wealthy individuals.

My testimony today contains three parts: (1) a brief reference to Circular 230, (2) a description of the Tax Section's corporate tax shelter legislative recommendations, and (3) an amplification of certain aspects of our legislative recommendations. But first, I want to say something about the corporate tax shelter problem.

The Corporate Tax Shelter Problem

We are aware that you may be told that there is no corporate tax shelter problem and that Congress does not need to take any action. Mr. Chairman, make no mistake about it. There is a serious problem, and it needs to be dealt with if we are to maintain any semblance of public confidence in the tax system. In the 1970's and early 1980's, when individual tax shelters were in vogue, the vast majority of American people justifiably became outraged when they learned through the press that certain high-income taxpayers were eliminating or substantially reducing their tax liabilities by means of uneconomic and frequently artificial transactions.

Today, transactions that have little or no economic substance, that are designed solely to defer or permanently eliminate tax liability, and that are premised on opinions that recite very questionable facts are being marketed to businesses of all sizes and to wealthy individuals. These transactions are not based on Congressionally mandated tax incentives, such as the low-income housing credit, but instead apply aggressive interpretations of the law in situations where the transactions would be dismissed out of hand by the taxpayers if it were not for the tax avoidance benefits of the transactions.

We are not in a position to estimate the impact on Federal revenues of the corporate tax shelter activity of the past several years. However, our experience as tax practitioners suggests that the level of tax shelter activity is very substantial. Many of the shelter transactions involve purported tax savings of tens of millions of dollars. As these transactions spread in the economy to smaller businesses and individual taxpayers, the level of activity will continue to grow. Should Congress fail to take appropriate legislative action, taxpayers and their advisors will be emboldened and become even more aggressive. At some point, after the inevitable publicity, the American people may justifiably ask their elected representatives why action was not taken to stop this tax avoidance activity when the abuses were brought to the Congress' attention.

Circular 230

I would like to refer to what I believe is a very important recent action by the Tax Section in proposing amendments to Circular 230, the rules promulgated by the Treasury Department that seek to regulate the conduct of practitioners who represent taxpayers before the Internal Revenue Service. Less than two weeks ago, on October 29, the Tax Section transmitted to the Treasury Department and the Internal Revenue Service proposed amendments to Circular 230 intended to impose a higher standard of conduct on lawyers and other practitioners who render certain opinions in connection with corporate tax shelters. Copies of our recommendations were sent to you, Mr. Chairman, to Mr. Rangel, and to the appropriate tax staffs, and a copy of our recommendations is attached to this statement.

Our recent action, recommending amendments to Circular 230, reflects a long-standing view of the Tax Section that the professions, including the legal profession, must do what they reasonably can to assure appropriate conduct of their members. We are confident that if the Treasury Department adopts our recommended changes to Circular 230, we will see a higher standard of conduct by all tax practitioners who render corporate tax shelter opinions affected by the recommended amendments.

Legislative Recommendations

Although we consider the revision of Circular 230 to be an important step in addressing the corporate tax shelter problem, it is not the only step. In addition, the Internal Revenue Service must audit these transactions and make clear to taxpayers, tax practitioners, and marketing organizations that it is prepared to assert

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[2] We also refer to these shelters as "transactions," although recognizing that the taxpayer's investment in a financial or other tax shelter product, or other taxpayer action, may not fit the traditional description of a transaction. We believe all such actions need to be addressed by any legislation.

both civil and criminal penalties where appropriate. We are pleased that Deputy Treasury Secretary Eizenstat and Commissioner Rossotti recently have stated publicly their concern with corporate tax shelters and their intention to take appropriate actions to curb this potentially harmful activity.

But, Mr. Chairman, there is a limit on what the Internal Revenue Service can do. Under the best of circumstances, it cannot detect all questionable transactions, it cannot devote audit resources to challenge all transactions it does detect, and it cannot litigate all of the cases that should be litigated. If the marketing of aggressive tax shelter transactions is to be constrained, it is vitally important to put added pressure on the marketing process.

The marketing of these transactions is predicated on the odds favoring success. Promoters understand that the IRS is unlikely to detect and challenge more than a small fraction of transactions. They also view applicable penalties as relatively minor and usually avoidable. They put these factors together to make a compelling case that the transaction makes economic sense, even though the transaction would not withstand judicial scrutiny. Corporate tax managers often believe that they have nothing to lose by entering into an aggressive tax shelter. Even if the claimed benefits are disallowed, they believe that they will be able to settle out the penalties and will be no worse off than they would have been if they had not entered into the transaction.

Our legislative recommendations are intended to accomplish four objectives. First, to encourage the private sector—taxpayers, tax advisors, and those who market corporate tax shelters—to carefully scrutinize the facts and the legal analysis of proposed transactions and consider carefully the appropriateness of the transactions under the law. Second, to level the audit playing field by assuring that the largest and most aggressive of these transactions are disclosed to the Internal Revenue Service on the tax return. Third, to make it clear to the Internal Revenue Service that Congress places emphasis on the audit of and challenge to questionable transactions. Fourth, to legislatively endorse a reasonable interpretation of the economic substance doctrine—an interpretation that we believe constitutes present law. We think these four objectives may be furthered by the following legislative actions.

1. *Require specific, clear reporting for a "large tax shelter."*

We recommend the enactment of a new Section 6115 of the Internal Revenue Code that would require the following tax return disclosure for a "large tax shelter," as defined.

a) A detailed description of the facts, assumptions of facts and factual conclusions (including conclusions regarding the business or economic purposes or objectives of the transaction) that are relied upon to support the manner in which the transaction is reported on the tax return;

b) A description of the due diligence performed to ascertain the accuracy of such facts, assumptions and factual conclusions;

c) A statement signed under penalties of perjury by the taxpayer's chief financial officer or comparable senior corporate officer with a detailed knowledge of the business or economic purposes or objectives of the transaction that the facts are true and correct as of the date the return is filed, to the best of such person's knowledge and belief. If the actual facts varied materially from the facts, assumptions or factual conclusions relied upon, the statement would need to describe such variances;

d) Copies of any written material provided in connection with the offer of the tax shelter to the taxpayer by a third party;

e) A full description of any express or implied agreement or arrangement with any advisor, or with any offeror, that the fee payable to such person would be contingent or subject to possible reimbursement if the anticipated tax benefits are not obtained; and

f) A full description of any express or implied warranty from any person with respect to the anticipated tax results from the tax shelter.

In the event a taxpayer fails to satisfy the Section 6115 disclosure requirements for a "large tax shelter," a new Section 6716 would impose a $50,000 penalty. If the nondisclosure were determined to be willful, criminal penalties also would apply. The penalty should be a no-fault penalty relating solely to the failure to disclose information on the tax return. Neither the amount of the new Section 6716 penalty nor its applicability should be dependent on whether or not the transaction in issue results in a tax deficiency. Moreover, the nondisclosure penalty would be totally unrelated to any penalty to which the taxpayer might be subject under Section 6662.

We believe the proposed Section 6716 penalty should be subject to a reasonable cause exception permitting abatement of the penalty if the taxpayer establishes that it exercised due diligence in attempting to accurately report the relevant informa-

tion (e.g., that it had appropriate fact-gathering procedures in place and that it did its best to follow them).

2. *Broaden the substantial understatement penalty to cover outside advisors, promoters and "tax indifferent parties."*

In any situation in which the substantial understatement penalty of existing law is imposed on the taxpayer, a penalty also should be imposed on any outside advisors who rendered favorable tax advice or opinions used in the promotion of the tax shelter, and promoters who actively participated in the sale, planning or implementation of the tax shelter. The same type of penalty should also be imposed on any "tax indifferent party," unless any such party can establish that it had no reason to believe the transaction was a tax shelter with respect to the taxpayer. The penalty should not be imposed on advisers who rendered opinions that comply with our proposed Circular 230 amendments.

Such penalties should be set at levels commensurate with the fees or benefits such parties stood to realize if the transaction were successful. In addition, separate procedural rules should be provided to assure such parties of due process, similar to the rules applicable in the case of penalties on tax return preparers.

3. *Define "large tax shelter" for purposes of proposed disclosure requirement.*

The definition of "tax shelter" presently contained in section 6662(d)(2)(C)(iii) should be retained. The term "large tax shelter" would be defined as any tax shelter involving more than $10 million of tax benefits in which the potential business or economic benefit is immaterial or insignificant in relation to the tax benefit that might result to the taxpayer from entering into the transaction. In addition, if any element of a tax shelter that could be implemented separately would itself be a "large tax shelter" if it were implemented as a stand-alone event, the entire transaction would constitute a "large tax shelter."

4. *Clarify that, where the economic substance doctrine applies, the non-tax considerations must be substantial in relation to the potential tax benefits.*

Most courts, as well as careful tax advisors, apply the economic substance doctrine by weighing the potential tax and non-tax results of a contemplated transaction. We think this is entirely consistent with long-standing congressional intent. Codification of this rule would provide a clear statement of the standard generally applied by courts under the economic substance doctrine, and would prevent reliance on unclear or conflicting judicial articulations of that standard in rendering opinions on tax-driven transactions. Any such codification would not, however, displace current law where the business purpose test is currently applied without a weighing of the tax and business objectives, such as the business purpose rules applied in the context of section 355 and in most tax-free corporate acquisitions.

5. *Articulate a clear Congressional policy that existing enforcement tools should be utilized to stop the proliferation of large tax shelters.*

Congress should make clear its view that examination of large tax shelter transactions by the Internal Revenue Service should be considered a tax administration priority. This should include the application of both civil and criminal penalties when appropriate.

Amplification of Certain Legislative Recommendations

Return Disclosure Requirement

a) Rationale.

We seek to achieve two objectives in proposing enactment of a "large tax shelter" return disclosure requirement. The first objective is to reduce the incentive to engage in transactions that would not withstand scrutiny on the ground that the likelihood of detection is small. Many tax shelter products and transactions are comprised of purportedly separate transactions or steps, often intended to obscure the overall transaction and frequently involving steps both within and outside the United States. As such, these transactions are extremely complex and often impossible to detect through information contained in a tax return, even by an experienced revenue agent. We believe Congress should mandate specific tax return disclosure obligations that will lessen the significant role that the likelihood of escaping detection currently plays in the corporate tax shelter equation. On the assumption that a return disclosure system is designed to be compliance friendly, as we believe it can, the argument that legitimate transactions may be affected should be considered with a healthy dose of skepticism. Whether legitimate in the eyes of the taxpayer or not, we would ask what is inappropriate about fair disclosure in a tax return context, even if the transaction is legitimate?

The second objective of the proposed return disclosure requirement is to encourage taxpayers and their advisors to pay careful attention to the actual facts underlying the proposed transaction prior to its consummation. We remain concerned, as we have previously testified, that often the facts assumed in analyzing the tax shelter are not the facts that actually occur. We believe the return disclosure requirement will underscore the importance of the actual facts of the transaction and encourage the taxpayer and its advisors to more carefully scrutinize the transaction in advance.

b) Certification by the chief financial or other senior officer.

We believe the proposed chief financial officer certification is an extremely important component of the return disclosure requirement for two reasons. First, the chief financial officer, because of his or her position in the company, can be certain that the business people within the organization who likely were involved in implementing the transaction, and, thus, who likely are most familiar with the actual facts, will be involved in preparation of the certification.[3] It will be in the direct interest of the chief financial officer to assure such involvement, and there will be much less risk that the taxpayer's return preparation personnel are isolated from the actual facts.

Second, because these transactions by definition are large (we suggest a $10 million reporting threshold) and because they are very aggressive, we think it is appropriate to encourage the taxpayer's senior management to personally consider the proposed transaction. If the chief financial officer knows that he or she will be required to execute the certification, we expect the officer will be much more interested in being personally advised of the transaction and of its risks before it is consummated.

Because of the potentially serious civil and criminal penalties that could result to a corporate officer who commits perjury by executing an inaccurate certificate, the legislation should provide appropriate separate administrative and judicial procedures that will accord the officer full due process. To this end, procedures should be established for reviewing officer certification issues that are independent of the audit process.

Mr. Chairman, the Tax Section attaches particular importance to the proposed large tax shelter return disclosure requirement because we believe it has the potential to accomplish two important objectives: (1) reduce the incentive to hide the ball from the IRS and (2) encourage a more careful factual and legal analysis of the transaction on the front end, before the transaction is consummated. If the disclosure requirement has this effect in even a fraction of the corporate tax shelter schemes currently on the market, it will make a significant contribution to tax administration and the American people's confidence in the tax system.

AFFIRMATION OF ECONOMIC SUBSTANCE STANDARD

We are aware that certain advisors take the position that any amount, even a *de minimis* amount, of risk, profit or other economic return is sufficient to satisfy the judicial economic substance doctrine. While we believe this view does not reflect present law, it is important to foreclose such assertions. It is for this reason that we make the relatively modest suggestion that Congress legislatively affirm that when a court determines the economic substance doctrine applies, the taxpayer must establish that the non-tax considerations in the transaction were substantial in relation to the potential tax benefits.

Our recommendation does not require the Congress to adopt a definition of economic substance or specify the particular circumstances in which the doctrine is relevant. We think both of these matters are best left to the courts where judicial discretion can be applied on a case-by-case basis. However, we think it is appropriate and important for the Congress to affirm what we believe to be current law, namely, that the non-tax considerations in the transaction must be substantial in relation to the potential tax benefits. It would also be helpful if Congress would make it clear that in evaluating the non-tax aspects of a transaction, such as potential economic profit, all of the costs associated with the transaction, including fees paid to promoters and advisors, should be taken into account.

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[3] Some businesses that will be subject to the reporting requirement may not have an employee denominated as the chief financial officer. Moreover, if the business is unincorporated, it may have no officers at all. Thus, it will be important for the legislation, or the legislative history, to make it clear that in such circumstances the certification must be executed by the person with responsibilities comparable to those of a chief financial officer.

CONCLUSION

One of the arguments that we expect the Committee will continue to hear from opponents of corporate tax shelter legislation is that the Internal Revenue Service already has the tools to deal with corporate tax shelters on its own, without legislation. For example, the Committee may be told that recent court decisions in the Commissioner's favor prove this point. We urge the Committee not to fall for this assertion. In spite of these recent decisions, we have observed no slowdown in the sales of tax shelter products; indeed, as we have indicated, we see a broadening of the market to smaller businesses and wealthy individuals. In addition, it is impossible to expect the Internal Revenue Service, even under the best of circumstances, to audit, let alone litigate, all of these transactions. Ours is a self-assessment system. It works best when taxpayers are motivated to take their return reporting obligations seriously. We think the only reasonable way to meaningfully impact the current corporate tax shelter phenomenon is to seek to modify the behavior of taxpayers, their tax advisors and those involved in the marketing of tax shelters through an improved self-policing system. Changes to Circular 230 will help. Increased audit activity by the Internal Revenue Service is very important. But, Congress also has a responsibility. We urge the Committee to take the lead by adopting legislation along the lines we recommend. As you proceed in your deliberations, please know that members of the Tax Section are prepared to lend a helping hand.

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I will be pleased to respond to any questions.

Section of Taxation Report to Amend 31 C.F.R. Part 10, Treasury Department Circular 230, to Deal With "More Likely Than Not" Opinions Relating to Tax Shelter Items of Corporations

This Report with proposed amendments to Circular 230 has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the Association.

REPORT

Treasury Department Circular 230, set forth at 31 C.F.R. part 10, provides rules for persons who practice before the Internal Revenue Service. Section 10.33 of Circular 230 deals with tax shelter opinions that are designed to be included or described in tax shelter offering materials that are publicly distributed. The rules in section 10.33 do not apply specifically to practitioners who provide "more likely than not" opinions to corporate taxpayers directly for possible use as legal justification in the event of an accuracy-related penalty assertion with respect to a "tax shelter item" as that term is defined in Treas. Reg. § 1.6662–4(g)(3). We recommend the addition of a new section 10.35 to fill this gap. The text of the proposed amendment to Circular 230 is attached.

New section 10.35 would provide minimum standards for practitioners who are asked to furnish their corporate clients with "more likely than not" opinions under section 6664(c) and Treas. Reg. § 1.6664–4(e) for the purpose of establishing the reasonable cause and good faith defense to an accuracy-related penalty by providing legal justification for the tax treatment of a tax shelter item. Because the possible application of section 6664 necessarily arises in audit proceedings before the IRS, Circular 230 should provide rules of practice with respect to such "more likely than not" opinions.

New section 10.35 provides that a practitioner providing a more likely than not opinion to establish a taxpayer's legal justification for the tax treatment of a corporate tax shelter item is required to evaluate and take account of all relevant facts; to relate the applicable law to those facts; to consider, to the extent relevant and appropriate, both the substance and the purpose of the plan or arrangement;[4] to identify and discuss all material tax issues; to identify and discuss the relevance and persuasiveness of the legal authority pertinent to the facts and material tax issues; and to contain a reasoned analysis of whether applicable authority supports the position taken by the taxpayer. The opinion must conclude unambiguously that there is a greater than 50-percent likelihood that the tax treatment of the tax shelter item would be upheld if challenged by the IRS.

[4] The substance and purpose requirement comprehends appropriate consideration of the judicial doctrines of substance versus form, economic substance, and business purpose on a generalized basis, without implying that any of these doctrines is exclusive of the others or more relevant than the others for opinion purposes.

The opinion must not be based on any unreasonable factual or legal assumptions. Assuming, rather than determining through reasonable inquiry, that a material fact exists would be considered unreasonable. Assuming, rather than analyzing and concluding, that a material legal issue would be resolved favorably would also be considered unreasonable. By way of example, it would be unreasonable for a practitioner merely to assume the existence of a business purpose for a transaction if business purpose is a material fact. It would also be unreasonable for a practitioner who establishes the existence of a business purpose to assume, rather than to analyze and conclude, that such a business purpose supports the transaction in question.

Except as provided below, a practitioner providing an opinion described in new section 10.35 must be knowledgeable in the relevant aspects of the Federal tax law at the time the opinion is rendered. The practitioner may not rely on an analysis of the Federal tax law prepared by another person with respect to any aspect of the taxpayer's treatment of the same tax shelter item, unless the practitioner is not sufficiently knowledgeable to render an informed opinion on a particular aspect of the Federal tax law. In such a case, the practitioner may rely on an analysis prepared by another practitioner who is knowledgeable with respect to that particular aspect of the law. For example, a practitioner giving advice as to the effect of a transaction in which the taxpayer will purchase an interest in a securitization trust holding a municipal bond may rely on the opinion of bond counsel that interest on the bond is exempt from Federal income tax under section 103.

A more likely than not opinion provided with respect to a corporate tax shelter item that does not state that it is being provided as legal justification for the treatment of such item on a tax return shall be presumed not to have been intended for such purpose. The Section of Taxation recommends that the Treasury Department consider the addition of a similar presumption to the regulations under § 6664.

This recommendation is made in a policy environment of increased attention to corporate tax shelter activities. See Treasury Department, White Paper, The Problem of Corporate Tax Shelters: Discussion, Analysis, Legislative Proposals, released July 1, 1999; Joint Committee on Taxation, Staff Penalty and Interest Study, released July 22, 1999. The Section believes there is a consensus among practitioners that the practice of giving more likely than not opinions that are intended to provide legal justification for the tax treatment of corporate tax shelter items should be addressed as a matter of proper practice as a supplement to continuing reform of underlying substantive law. See, e.g., James P. Holden, 1999 Griswold Lecture before the American College of Tax Counsel, Dealing with the Aggressive Corporate Tax Shelter Problem, 52 Tax Lawyer 369 (1999), making many points similar to this report and a recommendation from which the proposed amendment draws heavily.

The Section recommends the amendment of Circular 230 by adoption of the following amendments:

DRAFT OF PROPOSED AMENDMENTS TO CIRCULAR 230

Add a new § 10.35 to read as follows:

§ 10.35. "**More likely than not" opinions.—** (a) *Application of section* This section prescribes minimum standards for a practitioner who provides a "more likely than not" opinion for the stated purpose of establishing the legal justification of a corporate taxpayer under 26 C.F.R. 1.6664–4(e)(2) for the tax treatment of a "tax shelter item," as defined in 26 C.F.R. 1.6662–4(g)(3). This section also necessarily applies to opinions prepared for such a purpose that express a higher level of confidence than "more likely than not."

(b) *Requirements for "more likely than not" opinion.* A practitioner who provides an opinion to a corporate client for the stated purpose of establishing that, at the time a return is filed, the client reasonably believed that the tax treatment of a tax shelter item as reflected on the client's return was more likely than not the proper treatment, must, as of the time the opinion is rendered and subject to paragraph (b)(9), be knowledgeable in the relevant aspects of Federal tax law and must comply in good faith with each of the following requirements:

(1) *Evaluate all relevant facts.* The practitioner must make inquiry as to all relevant facts and circumstances and be satisfied that the opinion takes account of all such facts and circumstances. The opinion should not be based, directly or indirectly, on any unreasonable factual assumptions (*e.g.*, an assumption of a fact that is material to the analysis, such as an assumption that the transaction had a business purpose or an assumption with respect to the profitability of the transaction apart from tax benefits, or an assumption of a fact made by a valuation expert in connection with an appraisal).

(2) *Reliance on representations.* The practitioner may, where the circumstances indicate that it would be reasonable to do so taking into account the practitioner's prior experience with the client, rely upon factual representations by persons that the practitioner considers to be responsible and knowledgeable. If the information so represented appears to be incorrect, incomplete or inconsistent in any material respect, the practitioner must make further inquiry.

(3) *Relate law to facts.* The opinion must relate the applicable law to the relevant facts.

(4) *Consider substance and purpose.* The opinion must take into account, to the extent relevant and appropriate under applicable law, both the substance and the purpose of the entity, plan or arrangement that gives rise to the tax shelter item in question.

(5) *Identify all material tax issues.* The opinion must identify and discuss all material tax issues unless the opinion is provided solely with respect to a specific tax issue, as described by paragraph (b)(9).

(6) *Evaluate authorities.* The opinion must identify and discuss the relevance and persuasiveness of the legal authority pertinent to the facts and material tax issues.

(7) *Analysis.* The opinion must contain a reasoned analysis of whether applicable authority supports the position taken by the taxpayer. Such analysis shall be made in the manner described in 26 C.F.R. 1.6662–4(d)(3). The opinion must not assume the favorable resolution of any legal issue material to the analysis.

(8) *More likely than not assessment.* The opinion must unambiguously conclude that there is a greater than 50-percent likelihood that the tax treatment of the item would be upheld on the merits if challenged.

(9) *Reliance on analysis of others.* A more likely than not opinion may not rely on an analysis of the Federal tax law prepared by another person that relates directly or indirectly to any aspect of the taxpayer's treatment of the same tax shelter item, unless such analysis is limited to a specific tax issue (e.g., whether interest on a municipal bond is exempt from Federal income tax under section 103) with respect to which the practitioner is not sufficiently knowledgeable to render an informed opinion. In such a case, the practitioner may rely on the analysis of another practitioner who is sufficiently knowledgeable regarding such issue, but the practitioner must ensure that the combined analysis, taken as a whole, satisfies the requirements of this section.

(c) *Presumption.* A more likely than not opinion provided with respect to a corporate tax shelter item that does not state that it is for the purpose of providing the taxpayer with legal justification for the treatment of such item on a tax return shall be presumed not to have been intended for such purpose.

(d) *Effect of opinion that meets these standards. An opinion of a practitioner that meets the above requirements will satisfy the practitioner's responsibilities under this section. The persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion will be separately determined under applicable provisions of the law and regulations.*

Amend § 10.52(b) as follows:

A practitioner may be disbarred or suspended from practice before the Internal Revenue Service for any of the following: * * *

(b) Recklessly or through gross incompetence (within the meaning of § 10.51(j)) violating § 10.33, § 10.34 or § 10.35of this part.

Chairman ARCHER. Mr. Lifson.

STATEMENT OF DAVID A. LIFSON, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. LIFSON. Thank you, Chairman Archer. My name is David Lifson, and I am the chair of the Tax Executive Committee of the American Institute of Certified Public Accountants.

Corporate tax sheltering is posing a problem for the tax system, and one we stand ready to help you address. While you are sure on the right track here, I just hope you get on the right train. We strongly oppose the undermining of our tax system by complex, convoluted and confusing tax sophistry. Clearly there are abuses, and they must be dealt with efficiently.

We also strongly believe that taxpayers should be entitled to structure transactions to take advantage of intended incentives and to pay no more tax than is required by the law. Clearly the difficulty comes in when trying to draw a delicate balance in determining when the character of tax planning transactions morphs from legitimate to abusive.

The system is currently responding, but perhaps not fast enough for you as legislators. Recent court cases are evidence for this observation. The IRS is clearly responding, too, with their announcement of a new operational unit, and they will be even more effective in the future with the changes made by you through the restructuring act.

Because of the lack of consensus on the correct approach to legislation, we strongly urge a careful examination of the conflicting, often confusing proposals you are considering. After all, no one likes seeing the tax system gamed. No one likes feeling that some taxpayers are not paying their fair share. On the other hand, when you develop complex rules in highly technical areas that could affect Main Street, the yellow caution flag needs to be waved. I can foresee many businesses having to do uneconomic transactional analysis on normal business acquisitions to assure the government they are not subject to this special regime that is proposed by some.

This result would serve no one well. We urge continued focus on the objectives stated by the Chair in announcing these hearings, to quote you, Chairman Archer, to stop abuses while properly restraining new blanket authorities for the IRS that might chill legitimate business transactions. To this end we encourage the use of exceptions for transactions that have a business purpose or are consistent with the legislative intent of the law. None of the proposals before you contain such exceptions. If the government wants to place a greater responsibility on large gray-area transactions, it should enact clear rules to provide for enhanced disclosures, high standards for legal support, and higher penalties on failures in certain defined situations.

Call these reportable transactions, something a responsible corporate officer will freely disclose or decide not to engage in; not tax shelters that imply guilt. Encourage compliance, not disrespect for the system. Voluntary compliance is the cornerstone of our system. Use it. Use the de minimis exception; exempt smaller transactious, say, those involving less than 10 million in tax or 1 million in advisory fees, as the ABA has suggested.

We support a more effective disclosure regime both in advance and with return filings. We support higher penalties on reportable transactions that are not disclosed. We support a penalty regime that provides incentives for disclosure, the use of objective indicators to identify transactions the government wants to scrutinize, and evidence of due diligence by corporate officials in signing the

return disclosure, as well as high standards for tax opinion letters that apply to all tax shelter opinions. And we support effective penalties on third parties, some of whom are not currently subject to the rules of Circular 230.

We are very concerned about and cannot support a super 269 approach, a disclosure regime that requires the taxpayer and numerous third parties to disclose at the time a transaction is offered, or, in particular, a disclosure requirement that requires a 75 percent likelihood standard in the penalty regime.

In conclusion, we stand ready to continue our work in this area, to meet with your staffs to discuss and refine our proposals, and to try to improve the system to benefit the American people. Thank you for your consideration.

Chairman ARCHER. Thank you, Mr. Lifson.

[The prepared statement follows:]

Statement of David A. Lifson, Chair, American Institute of Certified Public Accountants

My name is David Lifson, and I chair the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). The AICPA is the national professional association for CPAs, and our more than 330,000 members are from firms of all sizes, and from business, education, and government. Our members work regularly with the tax laws that you write, and we have a strong interest in making the tax law fair, simple, and administrable.

I am pleased to present our testimony on "corporate tax shelters." For the last year, we have had a task force working hard on the issues that the Treasury and Joint Tax Committee staff studies have attempted to address. We have discussed the issues with our leadership and membership; we have met with representatives of the American Bar Association Tax Section and Tax Executives Institute to identify areas of consensus; and we have met with Treasury Department and Congressional staff. While we have made progress, there are still significant areas of difference and a lack of consensus on key issues. We are all concerned about the misuse of our tax system, but we are also concerned that legislation to curtail this activity not be so overly broad, vague, and punitive as to have a chilling effect on normal transactions of average business taxpayers. We urge restraint in legislating solutions until discussions can build a greater consensus on the best approach to the difficult and complex problem of narrowly but effectively targeting abusive corporate transactions, while leaving intact a taxpayer's ability to plan regular commercial transactions without fear of draconian sanctions.

In addressing corporate tax shelters legislatively, we encourage you to keep in mind that the system must work efficiently, so that taxpayers and practitioners can understand and the IRS can enforce the rules. The tax system works through compliance and enforcement, based on the broad powers that Congress has already given the IRS to curb abuses. Not every perceived abuse requires new legislation with its concomitant new regulations and rulings. Indeed, the government has prevailed in several very recent tax cases based on present law (*Compaq Computer Corp.*, 113 TC No. 17 (September 21, 1999); *IES Industries, Inc. v. U.S.*, No. C97–206 (N.D. Iowa Sept. 22, 1999); *Winn-Dixie Stores, Inc.*, 113 TC No. 21 (October 19, 1999); and *Saba Partnership, Brunswick Corporation, Tax Matters Partner*, TC Memo 1999–359 (October 27, 1999)), following last year's decisions in *ACM Partnership v. Commissioner* (157 F2d 231 (3d Cir. 1998, affg. in part T.C. Memo. 1997–115)) and *ASA Investerings Partnership* (1998–305 TCM).

We are also pleased with the recent announcement by the IRS that it is forming an operational group to target corporate tax shelter transactions. As we have stated in prior testimony on this subject, some of the problem is lack of enforcement of existing rules rather than the need for new rules. As the government becomes more successful in identifying and prosecuting tax shelter cases, taxpayers and shelter promoters will be curtailed from abusive transactions. Nevertheless, we do support efforts to raise the standards required of "more likely than not opinions" through changes to Circular 230, and believe the practices of those not currently subject to Circular 230 must be subject to meaningful penalties as well.

We specifically reject the imposition of a new "super 269" approach that is included in some proposals. Such a new regime would be imposed over and above current law requirements and would deny deductions, losses, or credits unless a com-

plex analysis demonstrates an appropriate level of pre-tax profit. This approach, combined with a presumption of non-economic purpose, is overly broad in targeting abuses, and would adversely affect many normal business transactions at a minimum by injecting a high level of uncertainty and requiring documentation of an analysis for tax purposes that has no other meaning or business purpose.

My comments today supplement and refine those we provided last Spring to the House Ways and Means Committee and Senate Finance Committee when we were addressing the President's budget proposals related to corporate tax shelters. I have attached our statement from the Senate Finance Committee hearing on April 27, 1999.

Disclosure of Corporate Transactions

We continue to strongly support an *effective* disclosure mechanism to advise the government of corporate transactions that warrant review. Structuring an effective disclosure regime requires balancing the amount of detail, the timing of disclosure, and the burden of disclosure on taxpayers and advisers.

Disclosure should provide enough information to the IRS to be helpful, but should not include excessive detail that will make their review difficult. For tax return disclosure, we would encourage the use of Form 8275, which contains a concise statement of the legal issues or nature of the controversy. This form could be adapted for corporate tax shelter issues, possibly with check boxes for indicators of transactions that the government might wish to review, such as the involvement of a tax indifferent party, indemnities for the benefit of the corporate participant in a transaction, or other characteristics that the Committee determines are appropriate.

While advance disclosure (that is, before the return is filed) would help the government in some cases, it could be burdensome and should be limited to those situations where it would be most useful to the government. For both advance and return disclosure, we suggest care be used to identify what the IRS can actually make use of at each point in time. Disclosure requirements for advance and return filing should be specific as to what is required, when, and by whom.

We recommend placing the burden of advance disclosure on the promoter, advisor, opinion-writer, or salesman, rather than the taxpayer. Requiring both the taxpayer and these third parties to disclose a transaction is burdensome and provides redundant information to the IRS. Advance disclosure by the third parties will be more helpful to the IRS in the timely identification of problem areas and will be more effective in curtailing abuses by these third parties at an early point in time. We suggest that each of the "responsible" third parties involved be responsible for the reporting, unless there is agreement that one of them will take responsibility. This will create the necessary tension between the parties to insure disclosure.

For disclosures in advance of filing, we encourage you to modify Section 6111 (registration of tax shelters). We suggest a "reportable transactions" regime as a substitute for the "tax shelter" transactions convention currently in place under Section 6111 to identify targets for pre-return disclosures. This approach would be more focused, less subjective, less laden with emotion, and would encourage disclosure.

In defining transactions to be disclosed on the return or in advance, we believe there is merit in the approach of developing fairly objective "indicators" of the sorts of transactions to which the government wants to give special attention. However, both Treasury and the Joint Committee staffs have suggested some indicators that we believe would sweep in many ordinary business transactions. For example, the proposed indicator of a permanent book/tax accounting difference, would include key-man insurance, purchased intangibles, and the use of stock options as employee compensation. Another proposed indicator would look at the economic substance of a transaction, using a pre-tax profits analysis that would result in a number of ordinary transactions being classified as "tax shelters." For example, many incentives that Congress enacted to encourage taxpayers to undertake transactions that are not susceptible to this bottom-line analysis, like the research credit or even charitable contributions, would have to be reported or be specifically excluded from this test in legislation. It would be impossible to compare the pre-tax profits with expected tax benefits in many ordinary transactions because the economic return is unknown, such as stock purchased on margin or real estate purchased with nonrecourse debt. Other normal business transactions, such as leasing, financing or advertising, are not susceptible to an analysis which requires a determination of the expected pre-tax return from the transaction. Indeed, the Treasury Department's study pointed out that the courts have been reluctant to employ this kind of analysis in testing the vitality of transactions for tax purposes.

We are particularly concerned that the five tax shelter indicators in the Joint Committee staff recommendations would automatically deem a transaction to constitute a tax shelter defined under current law as having "a significant purpose" of

avoiding or evading Federal income tax. Defining a corporate tax shelter by reference to having a "significant purpose" of tax avoidance or evasion has not proved helpful in determining the proper target, and even Treasury has not yet been able to produce regulations after two years. We believe the Joint Committee staff approach of using more objective indicators is better, but they should be used as a *substitute* for the current law standards of "tax shelters." These factors should be objective and could be adjusted as more information becomes available and new trends are identified. Also, the Joint Committee staff recommendation contains a double jeopardy—if a transaction does not fall within one of these indicators, the IRS could still argue that a significant purpose of the transaction is the prohibited avoidance or evasion, and thus subject to additional disclosure requirements and higher penalties. In short, from the government's perspective, it's "heads, I win; tails, you (may well) lose."

We urge consideration be given to developing a more neutral approach, such as our suggested "reportable transactions" regime. The results may well be the same: the need for disclosure and a potentially higher penalty structure, but the judgmental tone is removed and the issue becomes one of mechanical reporting, not of emotion. If a transaction satisfies an indicator, it is subject to a disclosure and enhanced penalty structure; if it does not, it should be subject to the normal penalty regime (including disclosure as an abating criterion).

Some of the proposals before you try to avoid affecting normal business transactions resulting from overly-broad indicators by exempting specific types of transactions. We recommend a different approach. If a broad economic purpose test is retained, we believe the best way to reach the Chairman's stated objective of not adversely impacting normal business and financial transactions is to provide exceptions for defined categories of transactions. Our categories would include transactions that meet a business purpose test, are consistent with the legislative intent of the applicable provision, or are expected to produce returns that are reasonable in relation to the cost and risk of the transaction.

Finally, there should also be a de minimis level below which transactions do not need to meet additional disclosure requirements or be subject to extraordinary penalties, and we agree with the American Bar Association's proposals for a minimum of $1 million in professional fees or $10 million in tax benefits. This will avoid application of this regime to smaller taxpayers and less-sophisticated practitioners. We note that some proposals offered would apply to individual taxpayers. We suggest that any higher penalties and disclosure requirements should apply to corporate taxpayers initially, and expanded to other taxpayers, if necessary, only after the reportable transaction regime is well established.

Penalties

We believe that the "reportable transactions" regime for disclosure could be carried over into the substantive penalty area under Section 6662(d).[1] A reportable transaction would have to be disclosed on the tax return or the taxpayer would face heavier penalties. Disclosure will help the IRS identify problem issues, and, coupled with penalties where a position taken does not have sufficient merit, will provide a strong deterrent against abusive transactions. For reportable transactions that are disclosed but that lack substantial authority and lack a sound opinion concluding "more likely than not" on the merits, the 20% penalty of current law should apply. A somewhat higher penalty on reportable transactions that are not disclosed would provide an economic incentive for disclosure as would our suggestion in earlier testimony that where the requisite standard is met and disclosure has been made, there should be no penalty.

We do not support the Joint Committee staff's proposed 75% likelihood standard. The current more-likely-than-not standard is comprehensible in application where the practitioner and taxpayer have to determine that they have the preponderance of authority. Even this is not easy in situations where little guidance or case law exists. Determining the degree of certainty to a specific percentage is virtually impossible, and will be difficult for the IRS and courts to apply. It would also set a higher standard than would be required to prevail on the merits of a case.

We do not believe there should be a penalty on the taxpayer for failure to disclose on a tax return where there is no understatement of tax. Although we understand the intent of this proposal, a flat-dollar amount would not act as a deterrent, and other formulations of the penalty are too complex for the potential benefit that

[1] In Short, our recommendation is not intended to layer another regime for "reportable transactions" on top of those in current law, but to stimulate consideration of a means to restructure and simplify the substantial understatement penalty for certain transactions, and to better coordinate those with the disclosure requirements.

might be provided. Similarly, we do not support any strict liability penalties, believing that the IRS should have the ability to waive penalties when justified.

We believe that a standard must be established under Circular 230 for all tax shelter opinion letters. The current rules should be expanded to cover "tax shelter" opinions outside the third party context and should be better coordinated with the existing penalty rules. There are other aspects of Circular 230 that can also be brought to bear on abusive tax shelters, and we will work with the bar, enrolled agents, and the Treasury to improve Circular 230. Within the AICPA, we are reviewing the ethical conduct of practitioners involved in corporate tax shelter cases, and are determined to maintain the highest level of responsibility of our members.

Most individuals who practice before the IRS are responsible professionals who have nothing to do with abusive tax shelters. Unfortunately, many individuals involved in developing, advising, and selling of tax shelters are not professionals who are subject to Circular 230 (that is, not an attorney, CPA, or enrolled agent). The penalties for aiding and abetting the understatement of tax liability could be expanded to include these third parties. Also, promoter and advisor penalties should be imposed for failure to disclose when transactions are developed and sold, and these could be fashioned along the lines of Section 6707, as a percentage of fees, and could be expanded to apply to investment bankers, opinion writers, insurance companies, and others who are involved in such transactions. For practitioners governed by Circular 230, sanctions can include suspension from practice before the IRS or disbarment, and we would encourage tough penalties for others who engage in abusive conduct.

Due Diligence by Corporations

We have been told that a common problem with abusive tax shelters is that tax opinions on certain transactions often do not match the actual facts. This has led to proposals that corporate officers be required to be more diligent in their examination of positions taken in tax returns. We support the requirement of a "corporate officer attestation" on the return, disclosing reportable transactions. Our suggestion is that a *corporate official having knowledge of the facts*, rather than one having a position with a particular title within the corporation, would be required to sign the attestation. The legislative report should make clear that the official could reasonably rely on expert opinions as to the tax law, valuations, etc., and on other responsible corporate personnel as to factual matters. We do not believe that attestation should carry personal liability, as this extreme sanction may not be appropriate for the conduct of the corporate official. Also, large companies frequently insure their officials against liability so that personal liability would often be deflected.

Conclusion

We strongly oppose the undermining of our tax system by convoluted and confusing tax sophistry. Clearly, there are abuses and they must be dealt with effectively. However, we have a complex tax system and believe that taxpayers should be entitled to structure transactions to take advantage of intended incentives and to pay no more tax than is required by the law. Drawing this delicate balance is at the heart of the issue we are addressing today. We urge you to continue the difficult discussions that develop from today's hearings until a greater consensus can be reached as to the best possible legislative approach. We offer our ideas and assistance in developing an effective and efficient approach to curtailing abusive tax shelters.

[An attachment is being retained in the Committee files.]

Chairman ARCHER. Mr. Shewbridge.

STATEMENT OF CHARLES W. SHEWBRIDGE, III, CHIEF TAX EXECUTIVE, BELLSOUTH CORPORATION, ATLANTA, GEORGIA, AND PRESIDENT, TAX EXECUTIVES INSTITUTE, INC.

Mr. SHEWBRIDGE. Thank you, Mr. Chairman.

Mr. Chairman, I am Chuck Shewbridge, chief tax executive for BellSouth Corporation in Atlanta, Georgia. I am here today as president of Tax Executives Institute, the preeminent group of in-house tax professionals in North America. Our 5,000 members rep-

resent the 2,800 largest corporations in the United States and Canada. We appreciate the opportunity to testify because this subject is of vital importance to the tax system.

Rather than summarizing my entire testimony, I wish to highlight two important issues.

Mr. Chairman, TEI's perspective differs from that of other organizations represented on this panel. The Institute does not represent the so-called tax shelter promoters and developers who either sell or facilitate the transactions, and we do not represent the professional advisers who opine on the legitimacy of the arrangements. Rather, TEI members work directly for the corporations that enter into business transactions that require an analysis of their tax benefits and burdens. In other words, TEI members are in the thick of it. We, along with the government, have the most at stake in trying to craft a workable solution to this challenge.

Before proceeding, Mr. Chairman, I want to endorse a comment that Congressman Doggett made last week. He recommended that both sides avoid immoderate rhetoric, which I interpret as meaning we should act on facts and not on feelings. Thus, I think it is both unfair and inaccurate to make blanket statements about the cause and scope of the tax shelter problem. And if I might, I wish to register my particular disagreement with the comment in the ABA's written statement that ''corporate tax managers often believe they have nothing to lose by entering into an aggressive tax shelter.'' Yes, there may be so-called bad actors in the tax community who promote, opine on and otherwise facilitate, or participate in aggressive transactions. I believe, however, that we must guard against overstatement.

I have been a tax professional for nearly 30 years and have been employed by BellSouth for half of that period. As the company's senior tax official, I am ultimately responsible for the 40,000 Federal, State, local and foreign returns we file annually. BellSouth's 1998 Federal income tax return, which I signed earlier this year, reflects aggregate tax payments of more than $1.6 billion. Given the size of those numbers, and given the fact that I sign BellSouth's tax returns under penalties of perjury, it should go without saying that I take my job, including my responsibility to the tax system, seriously. So do my colleagues at TEI.

Although I question some of the rhetoric that has been used discussing tax shelters, I think it is very important to note significant areas of agreement. We agree that over aggressive tax-advantaged products are being marketed. We agree that the IRS must do more to challenge and curtail these transactions, including raising practitioner standards and, where appropriate, asserting penalties more frequently. And we agree that better, fuller disclosure, including early warning disclosure by promoters, lies at the heart of successfully dealing with the situation.

Where we disagree, Mr. Chairman, is in very important details. First, as an organization of women and men who will have to comply with whatever disclosure regime is enacted, TEI does not believe that concerns about the definition of a corporate tax shelter can be cavalierly dismissed. It has been suggested that a tax shelter is any transaction where the potential business or economic benefit is immaterial or insignificant, in relation to the tax benefit.

With three decades experience, I think I know what is meant by the words "material" and "insignificant," and I strongly believe that BellSouth has engaged in no abusive tax shelters. But I am very much concerned that some time in the future a revenue agent may disagree with me. At that point the issue will be joined as both sides may be forced to engage experts to argue over the meaning of "significant" and "material" and, in the case of the ABA's proposal, whether the $10 million disclosure threshold has been crossed.

Mr. Chairman, TEI believes it is critical to know what we are talking about. The definition of "tax shelter" must be as objective as possible. Thus, we look forward to working with the Treasury and the congressional staffs and our colleagues in the practitioner community in refining the definition of corporate tax shelters.

The second issue I wish to discuss is the proposal that the chief financial officer or another senior officer be required to certify that the facts disclosed about a tax shelter transaction are true and correct. TEI believes the proposal misses the mark. It misapprehends the role of the tax department as well as the CFO, it impugns the integrity and professionalism of both, and it ignores how the provision would adversely affect the examination process.

The proposal is flawed because it proceeds from the faulty premise that companies unknowingly enter into major transactions, and that the people who prepare and sign billion dollar corporate returns do so lightly. I certainly do not. It is totally without basis to say that a company's senior officers would permit abusive transactions to go forward but for the sanctions that would flow from the proposal.

TEI's concerns, however, go beyond the proposal's attack on the professionalism of corporate tax directors. It poses a serious threat to tax administration. If enacted, the proposal could lead to focus not on the underlying transaction, but on the CFO's statement. Hence the key would not be whether a transaction passes muster under the law, but rather "what did the senior officer know and when did he know it." We regret that the proposal could easily spawn suspicion and distrust comparable to that which existed in the 1970s concerning questionable payments to foreign persons.

In conclusion, TEI supports meaningful action in this area, but before legislation is enacted, the proposal must be refined. We look forward to working with the Committee to this end. Thank you.

Chairman ARCHER. Thank you, Mr. Shewbridge.

[The prepared statement follows:]

Statement of Charles W. Shewbridge, III, Chief Tax Executive, BellSouth Corporation, Altanta, Georgia, and President, Tax Executives Institute, Inc.

I am Charles W. Shewbridge, III, Chief Tax Executive for BellSouth Corporation in Atlanta, Georgia. I appear before you today as the President of Tax Executives Institute, the preeminent group of corporate tax professionals in North America. The Institute is pleased to participate in the Committee's hearing on corporate tax shelters and to provide, among other things, comments on the proposals and recommendations offered by the staff of the Joint Committee on Taxation and the Treasury Department.[1]

[1] *See* Staff of the Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (JCS–3–99) (July 22,

Continued

Mr. Chairman, this subject is a very important one to TEI members, to the tax community generally, and to the tax system as a whole. In the press release announcing this hearing, Chairman Archer identified the following five issues for consideration:

- The nature and scope of the perceived corporate tax shelter problem;
- The manner in which the IRS and the courts are currently addressing corporate tax shelters;
- Additional steps that the Administration could take under current law to address such tax shelters;
- Additional legislation that might be necessary to address corporate tax shelters; and
- Procedures the Administration has in place or could adopt, or that Congress could enact, to ensure that new or existing enforcement tools brought to bear on corporate tax shelters do not interfere with legitimate business transactions or make more difficult the application of an already complex income tax.

After providing background on Tax Executives Institute and my own experience as a tax executive, I will address each of these issues.

I. Background: The Perspective of the In-House Tax Professional

Tax Executives Institute was established in 1944 to serve the professional needs of in-house tax practitioners. Today, the Institute has 52 chapters in the United States, Canada, and Europe. Our 5,000 members are accountants, attorneys, and other business professionals who work for the largest 2,800 companies in the United States and Canada; they are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws. Hence, TEI members deal with the tax code in all its complexity, as well as with the Internal Revenue Service, on almost a daily a basis.[2] TEI is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. Our background and experience enable us to bring a unique and, we believe, balanced perspective to the subject of corporate tax shelters.

Put another way, TEI's perspective differs from that of other organizations that have commented on this issue. The Institute does not represent the so-called tax shelter promoters and developers (including investment bankers) who either sell or facilitate the transactions. We do not represent the professional advisers (be they attorneys or accountants) who opine on the legitimacy of the arrangements. Rather, TEI's members work directly for the corporations that regularly enter into business transactions that require an analysis of their tax benefits and burdens. These companies have professional staffs dedicated to minimizing their tax liability while ensuring compliance with the law. To this end, these companies evaluate particular transactions (whether developed by their own staffs or brought to the companies by outside advisers or promoters), decide whether or not these offerings pass muster—not only in terms of the substantive requirements of the tax law but, importantly, in terms of their own business needs and corporate culture—and, if they proceed, report the transactions on their tax returns and defend them on audit. Ultimately, of course, these companies face potential exposure to sanctions (and public opprobrium) should their analysis of a transaction not be sustained. In other words, TEI's members are in the thick of it. We along with the government have the most at stake in trying to craft an equitable tax system that is administrable.

Although I am here today on TEI's behalf, I wish to provide some context for my testimony about my role as Chief Tax Executive for BellSouth Corporation. I have been a tax professional for nearly 30 years, and have been employed by BellSouth for half of that period. As the company's senior tax official, I am ultimately responsible for 40,000 federal, state, local, and foreign returns that BellSouth files each year. The company's 1998 federal income tax return, which I signed earlier this year, reflected an aggregate federal income tax liability of more than $1.6 billion.

Given the size of that number, it should go without saying that I take my job seriously. In discharging my duties, I oversee a staff of more than 100 people. We see our job as twofold—first, to ensure BellSouth's compliance with the state, local, federal, and international tax laws and, second, to serve the company's shareholders by ensuring that we pay only the taxes required by law. This second facet of the

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1999); Office of Tax Policy, U.S. Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (July 1999).

[2] Most of the companies represented by our members are part of the IRS's Coordinated Examination Program (CEP), pursuant to which they are audited on an ongoing basis.

job is not new and it is not something that we shrink from defending. Concededly, those who seek to influence the debate by the language they use pejoratively describe today's tax department as a "profit center,"[3] but the desire to reduce—and the legitimacy of reducing—one's tax liability is as old as the Rosetta Stone[4] and as legitimate as seeking shelter from the cold or rain.[5] With due respect, TEI suggests that those who wish to consign corporate tax departments to the role of scriveners, filling out tax returns, fundamentally misunderstand the historical, and we submit wholly proper, role of in-house tax professionals. Similarly, those who proceed on the assumption that tax executives neither understand nor willingly embrace our professional and legal responsibility to ensure our companies' compliance with the tax laws do us, our companies, our shareholders, and—equally important—the tax system a disservice. To be sure, there may be taxpayers who willfully or inadvertently cross over the line, just as there may be practitioners, promoters, revenue agents, government lawyers, and others who do the same. It would be a mistake, however, without sufficient empirical evidence to suggest that the problem is pandemic.[6] Let there be no mistake: TEI supports reasonable administrative, judicial, and legislative steps to address the tax shelter issue, but the steps must be measured, targeted, and based on fact, not feeling. Thus, we take to heart Congressman Doggett's statement last week that "immodest rhetoric" has no place in this debate. We regret, however, that such rhetoric seemingly emanates more often from those seeking to enact legislation than from those who seek to clarify its scope and effect. While we agree that if the tax system does not respond to noncompliance or to sham transactions, public confidence in the fairness of the system will be diminished, we also believe that public confidence can be equally impaired by the enactment of overreaching and overbroad legislation.

II. What is the Nature and Scope of the Perceived Corporate Tax Shelter Problem?

Before enacting expansive legislation dealing with corporate tax shelters, Congress is well advised both to ask and to answer the question "What is meant by the term 'corporate tax shelter'?" It is not a question whose answer can be assumed. It is likewise not a question whose answer can be put off indefinitely. Whether you view the solution as lying in increased disclosure, the enactment of an economic substance doctrine or business purpose test, the imposition of new penalties, or "just" the racheting up of the IRS's enforcement activities, the definition must be both knowable and known. At this junction, TEI questions whether it is.

Thus, the Treasury Department and the staff of the Joint Committee on Taxation have both issued substantial and serious studies that provide much food for thought on the subject of corporate tax shelters. Both have devoted considerable resources to identifying the scope of the problem from their perspectives and to crafting proposed substantive definitions of "corporate tax shelter" that attempt to measure the tax benefits of a transaction against its economic substance. Although we greatly respect the expertise and good faith of those involved—although we very much appreciate their efforts to date to respond to taxpayer and tax practitioner concerns and to refine their approaches—we remain concerned that the proposals rely too much on amorphous and unworkable concepts that pose challenges to tax adminis-

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[3] The Bureau of National Affairs recently reported that a senior Treasury Department official had said that so-called abusive shelters "have arisen at a time when the culture of corporate tax departments has changed from one in which compliance was its primary function to one in which it is expected to generate money-saving opportunities." "Piecemeal Solutions to Tax Shelter Problems Contribute to Growth, Treasury Officials Says," *BNA Daily Tax Report No.* 210, at G–8 (November 1, 1999).

[4] Charles Adams, For *Good and Evil: The Impact of Taxes on the Course of Civilization* 15–25 (1993).

[5] That tax planning by itself violates no moral code or substantive provision of the tax law has long been confirmed by the courts. Perhaps the most famous formulation of this axiom is Judge Learned Hand's: "[A]nyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935) ("[T]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.").

[6] While recognizing that the precise level of noncompliance owing to so-called tax shelter activity may be difficult to quantify, TEI has been very much concerned about broad statements of the enormity of the problem without empirical support. We are pleased that the IRS recently announced its intention to attempt to identify the scope of the problem. Assuming the methodology of the IRS's initiative is sound (and does not rely on revenue agents and others self-defining tax shelters as any transaction that produces a tax benefit they disagree with), it should meaningfully contribute to the process.

tration and may well sweep into the "tax shelter" net many legitimate transactions for the simple reason that they produce a tax benefit to the taxpayer.

Indeed, we are disappointed that some believe that lack of clarity is a virtue. Thus, the Treasury Department has previously framed the issue as between "rules" and "standards" (the latter being more general) and has recently suggested that what is necessary is a simple *ex ante* standard basically providing "Thou Shalt Not Abuse the Tax Code."[7] TEI is concerned, however, that such a hortative approach to the Nation's heretofore rules-based tax system could be counterproductive, ultimately disrupting routine business transactions by emboldening revenue agents or others to challenge any tax planning idea or transaction as a corporate tax shelter.

In other words, unless the definition is clear—or, at least, considerably clearer than it currently is—there will remain too great a possibility that the vague label "tax shelter" will be invoked as a shibboleth to cut off debate. To be sure, the effect of such a broad-brush approach may be to prevent certain abusive transactions, but it may also be to vitiate a taxpayer's right to minimize its tax obligations without first examining the facts and circumstances of a particular transaction and then assessing how its business purpose and economic substance comport with the explicit provisions of the Internal Revenue Code.[8] Thus, TEI submits that any legislative action addressing abusive or over-aggressive transactions must acknowledge the role of legitimate tax planning to minimize corporate tax expense. Legitimate tax planning can include transactions undertaken solely for tax reduction purposes, such as financing a company with the issuance of debt rather than equity,[9] and a taxpayer should not have to proceed through litigation to validate legitimate tax planning.

We have gone on at some length about the definitional problems not because we seek to staunch any meaningful action by the Treasury Department, IRS, and Congress, but rather because we take seriously our obligation to help improve the system. TEI agrees that the current situation cannot be ignored. As tax executives, we see the challenge to the tax system every day. The unrelenting complexity of the law breeds opportunity.[10] The interaction of various intricate provisions of the Internal Revenue Code leads to uncertainty for taxpayers about the proper limits of tax planning and the line between legitimate and illegitimate transactions. Moreover, the uncertainty encourages some—especially those who stand to reap substantial fees and rewards with little or no risk of loss—to abuse or game the system. While the evidence is only anecdotal, TEI is very much concerned that abusive products or transactions are being developed, marketed, and purchased. In our view, this phenomenon poses a challenge to the efficacy of the tax system. If the problem of abusive products is not addressed, the integrity of the tax system may be weakened

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[7] *E.g.*, "Piecemeal Solutions to Tax Shelter Problems Contribute to Growth, Treasury Officials Says," *BNA Daily Tax Report No.* 210, at G–8 (November 1, 1999) (remarks of Joseph M. Mikrut, Treasury's Tax Legislative Counsel).

[8] Stated differently, we fear that without clear limits, "corporate tax shelter"might become little more than the word "glory" in *Through the Looking Glass:* meaning whatever a revenue agent, like Humpty Dumpty, says it means. Lewis Carroll, *Through the Looking Glass* 186 (Signet Classic 1960) ("'When I use a word ['glory'], Humpty Dumpty said, in a rather scornful tone, "it means just what I choose it to mean—neither more nor less.'").

[9] The need to recognize that actions can be wholly motivated by tax considerations and still be proper is illustrated by the following, concededly simplistic example: A woman is walking down the street and comes upon a homeless person, asking for money so he can buy something to eat. If the woman pulls a five-dollar bill out of her pocket and hands it to the man, she has effected a transaction that has an economic cost to her but no favorable tax consequences. Now assume she walks the man across the street to a homeless shelter that has secured tax-exempt status. As the homeless man enters the soup line, the woman writes a check for a tax-deductible contribution to the shelter. She has engaged in essentially the same economic transaction but has taken additional steps, arguably only to secure the tax benefits of writing the check to the charity running the homeless shelter. Should she be denied a tax deduction for her contribution to a charity—in the nomenclature of the day, a tax-indifferent party—because her motivation for the action generating the deduction was solely to reduce her tax liability?

[10] TEI believes it is necessary to recognize the part that Congress, the Treasury Department, and the IRS each play in creating an environment in which so-called corporate tax shelters can flourish. Each of the government players, too, bears responsibility—for how the law reads (warts, "discontinuities," and all), how it is interpreted, and how it applies. Thus, TEI must acknowledge its frustration that the Administration has not sought to address either the complexity that characterizes the tax law or the unfair, one-sided provisions that, while crafted for a "pro-government" purpose, are often turned on their head by taxpayers in what is later deemed to be a tax shelter. For example, the contingent payment regulations that the taxpayer invoked in the *ACM* case were drafted by the government in a manner to be used *against taxpayers*; the taxpayers in that case simply tried to utilize the rules for their own benefit. An even-handed rule would not have presented even the opportunity for abuse.

or, at a minimum, the perception of the tax system's fairness impaired. Hence, action is required.

At the same time, the problems with the current proposals can likewise not be ignored. There is no simple, easy solution to the corporate tax shelter "problem." The key is realistically assessing the causes of the problems and then designing measured, balanced approaches to dealing with them without adding even more complexity to the already overburdened tax law. In the final analysis, rules must be developed that encourage all participants to exercise self-restraint. Ultimately, it is the corporation that is responsible for what is reported on its tax return, but in our view it is wrong to suggest that the problem lies only with taxpayers themselves and that the solutions should be directed only at them. Accordingly, TEI is pleased that the Treasury Department, the staff of the Joint Committee on Taxation, and others have concluded that attention must be paid to both the promoters of tax-advantaged products and to the outside advisers whose opinions facilitate the marketing of such products. We are certainly not claiming that sophisticated taxpayers are "victims," but in our view the solutions must reach the organizations and advisers who put unduly aggressive "products" into play.[11]

III. The Manner in which the IRS and Courts Have Addressed Tax Shelters

When the Ways and Means Committee held its first hearing on the Administration's tax shelter proposals last spring, several witnesses testified that while the Department of the Treasury and the Internal Revenue Service had several tools at their disposal to combat "abusive" corporate transactions, the agencies had failed to make appropriate use of those tools. Perhaps more fundamentally, it was questioned whether the Treasury had sufficiently demonstrated that the provisions of the current tax code are inadequate to staunch the perceived growth of tax shelters. TEI agrees that there is a powerful array of tools available to address abuses—from substantive provisions already in the tax code, to the authority to issue notices and regulations to halt specific abuses, to the ability to target transactions for litigation using one or more common-law anti-abuse doctrines.

Experience teaches that these tools can be and have been successfully invoked to curb several questionable transactions. For example, there have been a number of cases in which the courts have upheld the IRS's challenge to the business purpose or economic substance of a transaction that generated significant tax benefits. *See, e.g., ACM Partnership v. Commissioner, 73 T.C.M. 2189 (1997), aff'd in part, rev'd in part*, 157 F.3d 231 (3rd Cir. 1998), *cert. denied*, 119 S. Ct. 1251 (1999); *ASA Investerings Partnership v. Commissioner*, 76 T.C.M. 325 (1998), *on appeal to Fed. Circuit; United Parcel Service of America, Inc. v. Commissioner*, T.C. Memo No. 268 (1999); *Compaq Computer Corporation v. Commissioner, 113 T.C. No. 17 (Sept. 21, 1997); IES Industries v. United States*, No. C97–206 (N.D. Iowa, Sept. 22, 1999); *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. No. 21 (Oct. 19, 1999); and *Saba Partnership v. Commissioner*, T.C. Memo. 1999–359 (Oct. 27, 1999). Indeed, the last five of these government-favorable decisions were issued in the past three months. Let me be clear, Mr. Chairman: TEI does not necessarily subscribe to the view that all of these decisions involved "corporate tax shelters," even assuming the government's challenge to the transactions at issue were properly sustained. We do believe, however, that the cases illustrate the arguments and resources—and power—the IRS can successfully bring to bear when it concludes that taxpayers have engaged in improper transactions.

In addition, the Treasury Department and the IRS have not been reticent to issue regulations, rulings, and announcements challenging the purported tax benefits of certain transactions. Most recently, the IRS issued Rev. Rul. 99–14, 1999–13 I.R.B. 3, which addresses so-called lease-in/lease-out (LILO) real estate transactions, which often involve the leasing of property by a foreign party, often a municipality, to a U.S. taxpayer, followed by the sublease of the same property by the U.S. taxpayer to the foreign party. Explaining that the transactions are structured to produce significant tax benefits based on the deduction of prepaid rent with little or no business risk, the ruling states that the IRS will scrutinize LILO transactions for lack of economic substance and, where appropriate, recharacterize these transactions for tax purposes based on their substance.[12]

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[11] TEI also believes that, since the problem extends beyond corporate taxpayers (with some of the suspect products' being sold to partnerships and individuals), any solution crafted by Congress should not be confined to corporations.

[12] Some examples of the Treasury Department's and the IRS's using their regulatory power to challenge certain classes of transactions include the partnership anti-abuse regulations

Continued

Finally, the Treasury has proven effective in persuading Congress to act to amend the Internal Revenue Code where legislation is necessary to prevent taxpayers from receiving unintended benefits. Thus, as the Chairman noted when calling this hearing, "since 1995, (Congress has) stopped $50 billion in tax abuses." An example of such legislation is the amendment earlier this year of section 357(c) to prevent the artificial creation of basis. See § 3001 of H.R. 435 (enacted June 25, 1999).

Nonetheless, TEI believes that more can and should be done to encourage the IRS to employ—within the bounds of sound administrative practices and the exercise of managerial discretion and congressional oversight—its current statutory and common law substantive and administrative tools to curb transactions that are perceived as tax shelters. This includes the assertion of existing penalties in appropriate cases. The IRS must identify its workload requirements in order to determine staffing needs. To our knowledge, this has not yet occurred. Accordingly, we believe that the IRS's current initiative to identify and quantify potentially troubling corporate transactions is commendable.

Moreover, Congress must bear up to its responsibilities and ensure that the IRS is consistently well-funded with appropriations. To be effective, the IRS must have a well-trained workforce, and nowhere is this more true than with respect to the complex transactions that have been challenged as corporate tax shelters. Congress should ensure that the IRS has stable funding to meet its ongoing training needs.

IV. Additional Steps that the Administration Can Take Under Current Law

Before enacting new legislation, the Ways and Means Committee is right to ask whether there are additional steps that can be taken under current law. TEI believes there are. More fundamentally, we believe that there are administrative and regulatory steps the Treasury Department and the IRS must take even if legislation is enacted to enhance the disclosure of questionable transactions or otherwise address the tax shelter issue. Stated differently, the tax shelter problem is not one that Congress alone can cure. There is no legislative panacea, no single step or series of steps that Congress can take and thereby relieve the Treasury and the IRS of their ongoing responsibility. The Treasury and the IRS must continue to play their roles and if they fail to do so, they should be held accountable.

For example, in 1997 Congress enacted a provision relating to the registration of corporate tax shelters. Section 6111(d) of the Code was intended to help the IRS obtain useful information about corporate transactions at an early stage in order to identify transactions that should be audited and then take additional action—through enforcement proceedings, regulatory changes, or targeted legislative action. The provision, however, does not become effective until the issuance of Treasury regulations, and to date no such regulations have been issued. It may be that section 6111(d) is flawed (for example, because it is keyed to the use of confidentiality agreements and an excessively broad "significant purpose" test), but if the Treasury proves no more willing or able to act under any new legislation than it has been under current law, we believe it is reasonable to question why new legislation should be enacted.

Section 6111(d) does not stand as the only provision that has not been effectively used by the Treasury Department and the IRS. Questions could also be asked about the government's use of section 7408, which gives the government the authority to enjoin tax shelter promoters, and section 7609(f), concerning the issuance of so-called John Doe summonses to promoters. There is also a question about the Treasury's and IRS's not toughening the rules of conduct that govern return preparers and other practitioners. Perhaps more important, some have questioned whether the IRS has made adequate use of section 269, which authorizes the IRS to disallow tax benefits in respect of acquisitions made to evade or avoid income tax. Surely before enacting a greatly expanded section 269 to disallow deductions, credits, exclusions, or other allowances obtained in tax shelter transactions, the Treasury Department and the IRS should be called into account for its current use—or disuse—of section

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(Treas. Reg. § 1.701–2), the anti-conduit financing regulations (Treas. Reg. § 1.881–3 and Prop. Reg. § 1.7701(l)–2), and recently proposed regulations concerning fast-pay stock (Prop. Reg. § 1.7701(l)–3). Moreover, the Treasury Department and the IRS have acted to pre-empt many transactions by formally announcing an intention to issue regulations attacking transactions with which they disagree. Examples of such administrative notices include those involving fast-pay stock (Notice 97–21, 1997–1 C.B. 407), foreign tax credit transactions (Notice 98–5, 1998–3 I.R.B. 49), and transactions involving foreign hybrid entities (Notice 98–11, 1998–6 I.R.B. 13). The Treasury has on occasion made its notices retroactive, which by itself dissuades taxpayers from undertaking transactions that the government might deem abusive. The foregoing list is not exhaustive, but it does illustrate the Treasury's and the IRS's willingness and ability to challenge abusive transactions without new legislation.

269. Similarly, we suggest that before Congress acts on proposals to double the accuracy-related penalty, it should receive testimony from the IRS on both how frequently the current 20-percent penalty has been asserted (and sustained by the courts) and whether there is any evidence that the level of the penalty is insufficient to encourage compliance.[13]

Stated simply, TEI believes that there can be no substitute for an effective enforcement program by the IRS. No statute or series of statutes, no single or group of *ex ante* pronouncements, can eliminate the need for a well-trained workforce that has the financial resources and the managerial will to get the job done. In other words, the Institute believes the Administration should utilize all appropriate enforcement tools currently at its disposal, including the wider use of focused information document requests and the assertion of penalties in appropriate cases.[14] The Treasury Department should also consider whether an amendment to the applicable penalty regulations—most notably, Treas. Reg. 1.6664–4(c), relating to a taxpayer's ability to rely on an adviser's opinion in establishing its eligibility for the reasonable cause exception—are appropriate.[15]

Lastly, Mr. Chairman, we believe that the Treasury Department and the IRS (as well as Congress) can alter the environment in which so-called corporate tax shelters can flourish by working to simplify the law and to apply it in an evenhanded manner. As previously stated, we believe many of today's so-called tax shelters are attributable to one-sided rules that were crafted for a "pro-government" purpose but subsequently turned on their head.

V. Additional Legislation that Might be Necessary to Curb Shelter Activity—And Legislation that Is Ill-Advised

To the extent Congress determines legislation is necessary, TEI believes that it must be measured and restrained. Any response must carefully balance the benefit of any legislative proposal against the possible adverse consequences, including the likelihood that the provision would unduly interfere with routine business transactions and legitimate tax planning, impose needless complexity, and inevitably operate as a tax increase. It is imperative that Congress not overreact and enact a general anti-abuse rule (sometimes referred to as a "super section 269" provision) that would permit IRS agents to disallow transactions based solely on a subjective finding that the taxpayer had a significant purpose of tax avoidance in entering into a transaction. Such a provision would be exceedingly disruptive to ordinary business transactions and tax planning.[16]

A. The Focus Should Be on Meaningful Disclosure

Disclosure of information to the IRS is a most effective element of tax enforcement. Corporations are already required to reconcile their book and taxable incomes on Schedule M–1 of the tax return.[17] Indeed, the examination of corporate taxpayers generally centers around the book and tax differences disclosed on that schedule. During the course of an examination, taxpayers must expend considerable resources

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[13] It may well be that compliance is affected more by the certainty (or uncertainty) of application than by the level of the penalty.

[14] Coincidentally with the controversy about corporate tax shelters, the IRS has built an impressive track record in cases it perceives as abusive. *See, e.g., Jacobs Engineering Group, Inc. v. United States*, 97–1 U.S.T.C. ¶ 50,340, at 87,755 (C.D. Cal. 1997), *aff'd*, 99–1 U.S.T.C. ¶ 50,335, at 87,786 (9th Cir. 1999); *The Limited, Inc. v. Commissioner*, 113 T.C. No. 13 (Sept. 7, 1999), as well as the cases listed on page 11 of this testimony. What was missing was the IRS's willingness and ability to successfully assert penalties against sophisticated taxpayers. Significantly, the IRS has begun to assert and the courts sustain penalties against large corporate taxpayers. See *Compaq Computer Corp. v. Commissioner*, 113 T.C. No. 17 (1999) and *United Parcel Service of America v. Commissioner*, T.C.M. No. 268 (1999). This is a significant development, for it not only underscores the continuing vitality of the common law business purpose requirement but cannot help but prompt otherwise aggressive taxpayers to modify their behavior.

[15] For example, revised regulations could provide that a taxpayer may not rely on the opinion of a professional adviser that fails to contain a complete and accurate description of the facts underlying the transaction.

[16] It is clear from the recent IRS victories in court that when the IRS becomes aware of a potentially abusive transaction, judicial doctrines including those relating to sham, economic substance, business purpose, substance over form, and step transaction—especially when coupled with existing statutes such as sections 446, 482, 7701(l), and 269—provide the IRS with significant tools to ensure that the system works. We are concerned that attempting to codify the common law doctrines could further complicate and confuse the system and undermine legitimate tax planning.

[17] Under section 6662, disclosure can have the effect of immunizing taxpayers from the accuracy-related penalty, but disclosure will not have this effect if a tax-shelter item is involved. Ironically, then, current law has the perverse effect of *discouraging* disclosure of such items.

explaining, justifying, and supporting the differences. As a result, it is odd that the Treasury and Joint Committee staff both focus on book-tax differences as an indicator of a corporate tax shelter. These differences are not so much "indicators" as they are an unavoidable byproduct of the Internal Revenue Code that Congress—often with Treasury's direct support—has crafted. Mr. Chairman, I do not believe my company had any corporate tax shelters on the 1998 tax return that was just filed in September. But I do know that we had more than 125 separate items disclosed on our company's Schedule M–1 reconciling book and tax income.

The country's largest 1,700 companies are subject to continual audit by the IRS as part of the CEP program, but proponents of legislation downplay the significance of this. Hence, the Joint Committee staff's study states that "audits of large corporations typically follow an agreed agenda of issues that is negotiated by the IRS and the corporate taxpayer" and both the Treasury Department and the Joint Committee staff refer repeatedly to the "audit lottery." Taxpayers do strive to work cooperatively with the IRS, but they certainly are not capable of "walling off" some issues from examination. In practice, it is the IRS audit team that determines what transactions will be scrutinized. It is the IRS audit team that determines what information it needs. And it is the IRS audit team that ultimately determines what adjustments to propose. Any implication that large corporate taxpayers can win the "audit lottery" by narrowing the scope of the audit does not reflect the realities of the examination process. Mr. Chairman, you and the Committee may be assured that when large taxpayers have a new, non-routine Schedule M–1 item on their return, it will be examined.

B. Possible Expansion of Disclosure Requirements

One deficiency in the current system is the lack of downside risk to those who promote corporate tax shelters.[18] This shortcoming could be addressed by imposing a disclosure requirement on promoters of particular types of transactions.[19] Indeed, promoter disclosure could effectively operate as an "early warning" system that enables IRS and the Treasury Department to evaluate products and issue guidance—whether in the form of notices, rulings, or regulations—shutting down transactions that are perceived as "abusive" before they proliferate. This will also enable the IRS to marshal its resources and focus on examining transactions, including those undertaken by non-CEP taxpayers (individuals and middle-market and small companies) for whom the perception of the risk of detection is skewed by the "audit lottery." TEI believes that an effective system will impose the obligation for *early* disclosure on the promoter.[20] Because taxpayers will be required to make a detailed disclosure on their tax returns in order to avoid penalties, we do not support the

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[18] Thus, TEI agrees with the Joint Committee staff and Treasury Department that the tax system may require adjustments to better balance the cost-benefit analysis undertaken by promoters. Otherwise, a promoter may have little incentive to stop marketing abusive products. We note that some have argued that promoter fees are the "oxygen" vital to the fire of tax shelter products and they have therefore proposed that promoter penalties should be as much as 50 percent of the fees earned on the product and, further, that they be crafted so that the promoters cannot avoid the incidence of the penalty by passing on the risk to clients. While TEI believes that these proposals may merit consideration, the Institute has not yet taken a formal position on them. We do believe, however, that should new promoter penalties be enacted, they should afford promoters an independent review process that is separate from the examination of the taxpayer's return. Moreover, any legislation should make it clear that where a taxpayer implements a sound tax planning idea in an abusive manner, penalties should not be imposed on promoters.

[19] While section 6111(d), once operative through the issuance of regulations, will require registration of more transactions, that provision may not work as intended.

[20] TEI believes that a key to an effective early warning system involving promoters is the development of clear "triggers" for disclosure. Hence, we suggest that a promoter's disclosure could be tied to (1) the receipt of a minimum level of fees by the promoter and (2) the presence of other "indicators" or "filters" in a transaction. One possible approach would require the promoter to file a statement with the IRS no later than 30 days after the receipt of $100,000 or more in fees from two or more taxpayers in respect of that product (or a substantially similar product). At a minimum, two or more tax shelter "indicators" or "filters" would be required (promoter fees plus some other indicator) for a tax shelter transaction to be found. The disclosure statement filed by the promoter would fully describe the product, the amount of fees collected, the name and employer identification number of the clients, and which indicators were triggered. Consideration should be given to affording promoters the opportunity to obtain an advance ruling on whether a product should be registered. The purpose of the disclosure is to alert the IRS that it might wish to examine the transaction. Whether through this or other means, taxpayers with transactions meeting two or more "indicators" should be required to provide complete and meaningful disclosure with their returns. While alerting the examiner to a potential problem area, TEI strongly believes that the indicators should be used *exclusively* to trigger promoter disclosures. Hence, any legislation should confirm that no inference should be drawn concerning the proper treatment of a transaction that is subject to early disclosure by a promoter.

imposition of a duplicate early disclosure requirement on taxpayers. As previously suggested, for early disclosure to have the intended salutary effect, the IRS and the Treasury must undertake to analyze and take appropriate action on the disclosed transactions.

In addition, TEI believes steps can be taken to enhance the value of return disclosures by taxpayers themselves. One means of ensuring that IRS examiners will not miss issues, even in respect of CEP taxpayers, is to require a taxpayer to attach a copy of the promoter's disclosure notice to the taxpayer's return. Furthermore, the specific types of information that must be disclosed on the return in respect of certain transactions could be specified, either by Congress in the statute or in regulations.

C. The Senior Corporate Officer Attestation Proposal Should Be Rejected

It has been proposed that Congress require the Chief Financial Officer or another senior officer to certify that the facts disclosed (or reported on a return) about a tax-shelter transaction are true and correct. Indeed, some proponents of legislation have characterized such an attestation requirement as a "linchpin" in any successful effort to curb abusive tax shelters. Even if enhanced disclosure is appropriate, we regret that this attestation proposal misses the mark. It misapprehends the role of the tax department as well as the CFO, it impugns the integrity and professionalism of both, and it ignores how an attestation provision would adversely affect the examination process. TEI strongly opposes its enactment.

Stated bluntly, the senior officer attestation proposal obfuscates the issue because it proceeds from a faulty premise that companies do not enter into major transactions knowingly and that the people who prepare and sign billion-dollar corporate returns do so cavalierly. Corporate tax returns are already filed under penalties of perjury, and while I will not presume to speak for all my peers, I defy the proponents of this proposal to identify a sufficient number of corporate tax directors who take their return-signing duty so lightly as to justify the attestation requirement. As one commentator wrote recently in *Tax Notes*: "[I]f the corporate tax manager does not have full knowledge of the facts of the corporation's tax-motivated transactions, why is he signing the return? And if he does not know what is going on, why is anyone's signature on the extra form necessary, except for show?"[21] Equally important, it is totally without basis for proponents to say that a company's CFO and the other senior officers who might be subject to the attestation provision would permit abusive transactions but for the sanctions that might flow from the proposal.

Mr. Chairman, TEI's objections to the attestation proposal go beyond its denigration of the professionalism of corporate tax directors. The proposal poses a serious threat to the efficient operation of corporate tax return preparation and, especially, the examination processes. If enacted, the proposal could lead to focusing not on the underlying transaction but on the attestation. Hence, the key would not be whether a transaction passes muster under the law, but rather "what did the senior officer know and when did he know it?" Such inquiries could well result in intrusive or threatening examination practices that the IRS Restructuring and Reform Act was enacted to prevent.[22] Indeed, the proposal could easily spawn suspicion and distrust about the entire return preparation and examination process comparable to that which existed during the era of the infamous "Eleven Questions" (relating to facilitation payments to foreign persons) in the 1970s.

For the foregoing reasons, we urge Congress to reject the senior officer attestation proposal.

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[21] Lee Sheppard, "Slow and Steady Progress on Corporate Tax Shelters," *Tax Notes*, July 12, 1999, at 194. Some proponents of the attestation requirement have previously expressed surprise at TEI's opposition to the proposal, suggesting that the requirement would take in-house tax professionals "off the hook" by transferring responsibility to the CFO or another senior corporate officer. Whether short sighted or not, we take our professional responsibility to our companies and to our systems too seriously to support such a "pass the buck" strategy.

[22] Specifically, we are concerned that revenue agents might use the possible assertion of penalties against the CFO as a lever in their negotiation of the underlying tax treatment with the corporate tax director. Thus, the discussion could go, as follows: "If you don't concede the merits of this transaction, I am going to refer your boss's attestation to the criminal investigation division." Although according the attesting officer due process rights in respect of any penalty assertion is important, we question whether that alone will ensure the provision is not used improperly. Similar concerns make us less than sanguine about requiring companies to publicly disclose tax penalties above a certain dollar threshold in their financial statements.

D. Changes to the Code's Penalty Structure Must Be Measured

Although TEI believes that the primary focus of Congress should be ensuring meaningful and timely disclosure of transactions, we recognize that a comprehensive approach to this subject requires an examination of the Code's penalty provisions, including most particularly the accuracy-related penalty and the multitude of standards governing taxpayers, tax practitioners, and tax-return preparers. In proceeding, we urge Congress to keep in mind the following:

1. We cannot help but comment on the complexity of the proposed penalty regime set forth in the Joint Committee Study. Although seeking to consolidate and simplify the various standards to which taxpayers, preparers, and promoters are subject, the Joint Committee staff was forced to create an 11 x 5 matrix to explain the proposal. Concededly, one of the columns was devoted to listing current law, but it remains that the proposal is highly complicated and supposes a level of mathematical precision that does not exist in respect of what in many cases are essentially judgment calls—does a transaction legitimately reduce taxes?

2. TEI is very much concerned about proposals to increase the accuracy-related penalty in respect of certain tax shelter transactions to 40 percent. Indeed, we suggest that a fundamental problem with the administration of the current 20-percent penalty is that it is so high that it is rarely asserted against corporate taxpayers. Where penalties are disproportionate compared with the conduct involved, agents may be inhibited from asserting such penalties. Witness, for example, the penalty for errors involving qualified plans before the intermediate sanction rules were enacted. Because the stated penalty—revocation of exempt status—was uniformly considered too harsh, agents rarely ever asserted it.[23] Thus, while steps should be taken to address the certainty of application, we do not at this time believe the level of the accuracy-related penalty should be increased.

3. TEI believes that taxpayers should generally not be subject to penalties if they make a complete and meaningful disclosure about a product or transaction in the tax return and satisfy the applicable standard (see comment 5 below). If the taxpayer fails to disclose a transaction that is subsequently deemed to be a tax shelter and the taxpayer does not prevail on the merits, the taxpayer should be subject *at most* to a 20-percent understatement penalty where it has substantial authority for its treatmentpercent of an item. On the other hand, if a taxpayer fails to disclose apercent transaction that should be disclosed because it meets objective disclosurepercent criteria *and* the taxpayer prevails on the merits of the issue, it may be appropriate to impose an information-reporting type penalty on the taxpayer, the rate of which should not generally be linked to tax benefits at issue.

4. Given the complex nature of the tax law, TEI believes the enactment of a strict liability penalty is wholly inappropriate. Penalties should be designed either to punish purposeful misbehavior or to provide an incentive to behave properly. Accordingly, we support the retention of the reasonable cause exception. We do, however, believe the scope of the exception should be clarified. Hence, TEI believes that opinion standards should be revised for purposes of the reasonable cause exception. Before relying on an adviser's opinion to avoid a penalty, the taxpayer must be able to demonstrate that the opinion is based on the actual facts of the taxpayer's transaction and not an assumed set of facts.

5. Although TEI believes that some adjustment to and harmonization ofs taxpayer, practitioner, and preparer standards may be appropriate tos encourage the filing of more accurate returns, we have concerns abouts proposals to raise the standards, in respect of both shelter and non-s shelter items. Let there be no mistake: The multitude of standards nows contained in the Code—more likely than not, realistic possibility ofs being sustained, substantial authority, reasonable basis, not frivolous—is undeniably confusing. The multiple standards have reduced taxpayers,s practitioners, and preparers to assigning mathematical probabilities tos each standard and then divining (to the extent possible) whether a proposed return position meets or exceeds the applicable standard. The clarity suggested by the use of such mathematical probabilities, however, is a false one, for the tax law is marked by many things, but mathematical precision is rarely one of them.

Regrettably, the false clarity of current law would be exacerbated under the Joint Committee staff's proposal to engraft a "highly confident" standard on the Code, which the staff defines as a 75-percent or greater likelihood of success on the merits if challenged. At one level, we are concerned that the combination of the "highly

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[23] A collateral effect of the excessive pension plan penalty was to discourage taxpayers from disclosing and correcting errors for fear that the action could result in disqualification. With the advent of the employee plans compliance resolution system and its graded rewards and penalties (*i.e.*, intermediate sanctions and penalties), taxpayers are much more willing to voluntarily disclose errors for administrative resolution.

confident" and "more likely than not" standards may unleash a torrent of disclosures that consumes valuable IRS resources and distracts revenue agents from issues more worthy of their scrutiny. Equally important, we are concerned the imposition of higher standards will leave taxpayers facing penalties where, several years after they grappled with the vagaries and interstices of the tax law, a revenue agent or court concludes—with the benefit of hindsight—that the taxpayer erred in concluding its position was "at least probably right" (under the "more likely than not standard") or "highly confident."[24] This concern is especially pronounced in light of the Joint Committee staff's recommendation that the reasonable cause exception of current law be repealed. (See comment 4 above.)

6. Congress should not make changes in this area in a vacuum and should resist the temptation to make ad hoc changes in the Code's penalty provisions. A comprehensive overhaul of the provisions, as was presaged at yesterday's hearing of the Subcommittee on Oversight, is preferable.

VI. Steps to Ensure that Legitimate Business Transactions Are Not Impeded

Mr. Chairman, in announcing this hearing you expressed a desire to explore the procedures the Administration has in place or could adopt, or that Congress could enact, to ensure that new or existing enforcement tools brought to bear on corporate tax shelters do not interfere with legitimate business transactions or make more difficult the application of an already complex income tax. We agree that this should be a primary consideration of the Committee. If legislation is enacted that is overbroad or unclear—if it does an insufficient job of defining what is acceptable and what is unacceptable—it is the corporate community as a whole that will suffer.

TEI believes that the recommendations contained throughout this testimony address this issue, but in summary we offer the following:

- The definition of corporate tax shelter cannot be assumed. It must be known. Thus, while we agree that there will not be as much "pressure" on the definition if a disclosure-based proposal is adopted (as opposed to changes to the Code's substantive provisions), the problems do not disappear. Unless the "indicators" or "triggers" are objective or relatively easy to apply, there will be a likelihood not only of massive are objective or disclosures ("just to be safe") but of potential abuse by revenue agents or courts using hindsight to impose penalties. Neither of these developments would be good for tax administration.
- To the extent a broad disclosure regime is adopted, any requirementts agents for "early warning" disclosure should be imposed on promoters rather than taxpayers. This would ensure that promoters of tax shelters will have a rather thanective or incentive not to market abusive transactions, without unduly burdeninge aather thanective or taxpayers. Taxpayers, however, should be subject to more meaningful return or disclosure requirements.
- Congress should reject the Siren's song of senior corporate office attestation. So, too, should it reject the allure of doubling penalty rates. The IRS and Treasury would be better advised to develop effective audit strategies and to build the case for the appropriate assertion of a penalty.
- The standards for taxpayers, preparers, and advisers should be harmonized.
- Last but not least, neither Congress nor the Treasury should shrink from their obligation to improve and simplify the substantive provisions of the tax law.

VII. Conclusion

Mr. Chairman, as evidenced by these comments, there are no magical solutions to the corporate tax shelter phenomenon. TEI believes the keys are (1) encouraging clear and meaningful disclosure by tax-shelter promoters and taxpayers; (2) substantially changing the risk-reward profile for tax-shelter promoters; and (3) clarifying that tax "opinions" based on assumed facts and circumstances unrelated to the taxpayers' will not be sufficient to excuse taxpayers from disclosure or understatement penalties. Solutions to the tax shelter dilemma must be carefully targeted and should not exacerbate the problem by adding further complexity to the Internal Revenue Code or by transforming a putatively neutral IRS examination process into an adversarial—even prosecutorial—search for "bad actors."

Tax Executives Institute appreciates this opportunity to present its views on the corporate tax shelter problem. Any questions about the Institute's views should be directed to either Michael J. Murphy, TEI's Executive Director, or Timothy J.

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[24] It should also be recognized that the person making the decision whether the taxpayer was "at least probably right" or assessing the correctness of the taxpayer's "highly confident" claim (*i.e.*, revenue agent, Appeals officer, or court) would not even reach that question until concluding that the taxpayer was wrong on the merits.

McCormally, the Institute's General Counsel and Director of Tax Affairs. Both individuals may be contacted at (202) 638–5601.

Tax Executives Institute, Inc.

CHARLES W. SHEWBRIDGE, III
President

Chairman ARCHER. Mr. Handler.

STATEMENT OF HAROLD R. HANDLER, CHAIR, TAX SECTION, NEW YORK STATE BAR ASSOCIATION

Mr. HANDLER. Thank you, Mr. Chairman. My name is Harold Handler. I appear in my capacity as chair of the Tax Section of the New York State Bar Association. Earlier this year we presented two reports on proposals relating to the phenomenon known as corporate tax shelters. In these reports we indicate our belief that there are serious and growing problems with aggressive, sophisticated and we believe in some cases artificial transactions designed particularly to achieve a tax advantage.

The problem with these transactions is twofold. There is, of course, revenue loss. But there is a second corrosive effect. The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system.

We believe there are several related steps in dealing with this phenomenon. First, the Service must increase its audit efforts and intensify scrutiny of these transactions, but diligent litigation alone will not, in our opinion, be sufficient to deter these transactions. Litigation is expensive, time-consuming and uncertain as to result. It fails to—and we believe it fails to catch a sufficiently large portion of these transactions to assure adequate deterrence.

There must be further steps taken to change the risk-for-reward ratio. The only downside risk at present, given the availability of reasonable cause opinions today which provide protection under the current law from any penalty, is some additional interest, but the possibility of benefit by avoiding tax completely is substantial. We believe this equation must be changed. If a taxpayer is considering a tax shelter transaction, the elements to be considered must include the likelihood of significant penalty if the claimed tax treatment is disallowed. Under a strict liability regime, taxpayer's reliance on professional tax opinion would no longer have the effect of eliminating the risk of the penalty. Corporate taxpayers would be forced to assume a real risk in entering into these transactions, and advisors would be induced to supply balanced and reasoned analysis rather than merely supplying reasonable cause as under current law.

There have been a number of proposals recently addressing this problem which we believe are significant positive steps in the right direction, and we support these efforts. These include H.R. 2255, the Treasury White Paper, and the joint Committee study in July. Of these three approaches to reasonable cause opinions, we prefer the H.R. 2255 approach, which would prohibit the ability of corporate taxpayers to rely on such opinions. As our reports indicate, increased disclosure is an essential corollary to any of these in-

creased penalty provisions, but more than disclosure is required. We believe it important for Congress to adopt as proposed in H.R. 2255 a strict liability approach to the accuracy-related tax shelter penalties by eliminating the reasonable cause exception to the imposition of such penalties for proscribed tax-motivated transactions.

We acknowledge the strict liability approach to accuracy-related penalties will put considerable pressure on defining appropriate cases. We have concluded on balance that it is acceptable to live with the effects of such strict liability when the imposition of the penalty, one, depends on the taxpayer's position ultimately not being sustained as a matter of current law; two, the amount of the penalty would be reduced if the transaction is properly disclosed; and three, that the penalties are targeted at corporate tax shelters as appropriately defined.

The critical element is therefore to define these suspect transactions in a manner that distinguishes artificial transactions designed to produce a tax benefit only from legitimate corporate tax planning, which we clearly believe is appropriate.

Our report includes a definition of the type of transaction which we believe should be subject to these penalties. Many of the elements of our proposal are also contained in H.R. 2255, the ″white paper,″ and also the Joint Committee Study and we would be pleased to work with the administration and Congress to clarify this approach and reconcile any differences.

Mr. Chairman, thank you for the opportunity of appearing today.

[The prepared statement follows:]

Statement of Harold R. Handler, Chair, Tax Section, New York State Bar Association

Mr. Chairman and Members of the Committee:

My name is Harold R. Handler and I appear in my capacity as Chair of the Tax Section of the New York State Bar Association. The Section has 3,000 tax professionals as members, and through its Executive Committee, prepares and disseminates between 25 and 40 analytic reports a year on various topics relating to Federal, state and local taxation.

Earlier this year, we presented two reports on proposals in the President's Fiscal Year 2000 Budget Proposals relating to the phenomenon known as corporate tax shelters. In these reports, we indicate our belief that there are serious, and growing, problems with aggressive, sophisticated and, we believe in some cases, artificial transactions designed principally to achieve a particular tax advantage. A good example is the transaction recently the subject of a Tax Court, and a Third Circuit decision in *ACM Partnership vs. Commissioner*. But this is not the only example, and our report attempts to detail a number of abusive corporate tax shelter transactions.

Tax shelter transactions take many complex forms, but typically include some if not all of the following elements: lack of business purpose other than tax reduction, absence of meaningful economic risk or reward, exploitation of uneconomic aspects of the tax code, and shifting of income to tax-exempt parties. Consider, for example, the "lease-in lease-out" (or "LILO") transaction described in a revenue ruling issued last spring (Rev. Rul. 99–14, 1999–13 I.R.B. 3). A US taxpayer purports to "lease" an asset (perhaps a town hall or a trolley system) from a foreign municipality, and to "sublease" the asset back to the municipality. The US taxpayer "prepays" and deducts the "rent" under its lease, funded by a non-recourse loan which is collateralized by the municipality depositing this prepayment with the lending bank to secure its obligation to make "sublease rent" payments over a term of years. The transaction serves no discernable business purpose, involves no meaningful risk to either party because of the circular flow of cash, and is intended to exploit uneconomic differences in accounting for the "lease" and the "sublease" so as to create "income" to the tax-exempt municipality and deductions for the US taxpayer during the initial part of the transaction.

Some might suggest that all is well now that the particular accounting rules that the taxpayer sought to exploit in the LILO transaction described in the Revenue Ruling have been changed by the promulgation this spring of final regulations under Section 467 of the Code. There are rumors abroad, however, of "son of LILO" transactions. Whether or not these particular rumors are true, it is undoubtedly the case that misguided creativity is being applied to concoct other tax avoidance transactions that have as little substance as the LILO transaction that the Ruling describes.

The problem with these transactions is two-fold. There is obviously an effect on revenue. While we are unable to estimate the amount of this revenue loss, anecdotal evidence and personal experience leads us to believe it is likely quite significant. But there is a second corrosive effect. The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in tax advantaged transactions.

There are no simple solutions to the problems posed by the corporate tax shelter phenomenon. We believe there are several related steps to dealing with this phenomenon. First, the Service must increase its audit efforts and intensify the scrutiny of these transactions. As an example, the recent government success in ACM and similar cases is a positive development. But audit scrutiny and diligent litigation alone will not, in our opinion, be sufficient to deter these transactions. In the first place, litigation is expensive, time consuming, and uncertain as to result. Moreover, we are convinced that it fails to catch a sufficiently large enough portion of these transactions to assure adequate deterrence.

There must be further steps taken to change the risk/reward ratio. The current equation is all too simple. Even responsible corporate financial officers, when faced with the choice of paying tax on some item of gain or other income may choose to engage in artificial transactions designed to eliminate the tax they otherwise would pay. The only downside risk at present, given the availability of "reasonable cause" opinions today, which provide protection under current law from any penalty, is some additional interest, which is likely to be at a somewhat higher rate than they would otherwise pay from more conventional lending sources. But the possibility for benefit by avoiding the tax completely is substantial, and far greater than the risk of somewhat greater interest cost.

We believe this equation must be changed. If a taxpayer is considering a tax-shelter transaction, the elements to be considered must include the likelihood of a significant penalty if the claimed tax treatment is disallowed. Under a strict-liability regime, a taxpayer's reliance on professional tax opinions would no longer have the effect of eliminating the risk of a penalty being imposed on corporate taxpayers engaging in corporate tax shelter transactions. Consequently, corporate taxpayers would be forced to assume a real risk in entering into these transactions, and advisers would be induced to supply balanced and reasoned analysis rather than supplying "reasonable cause" as under current law.

In our view, even if substantially greater resources were devoted to attacking corporate tax shelters under current law, the structure of our current penalty system ultimately would not provide adequate deterrence of corporate tax shelter activity. For this reason, we strongly support the approach of the Administration's proposal to increase accuracy-related penalties for defined corporate tax shelter transactions to encourage disclosure and deter risk taking by taxpayers. There have been a number of proposals recently addressing this problem, which we believe are significant positive steps in the right direction, and we support these efforts. H.R.2255 proposes a statutory definition of "non-economic tax attributes," which uses many of the same attributes that were included in our proposed definition in our April Report and eliminates the ability to rely on a "reasonable cause" opinion. The Treasury "white paper" in July proposed imposing additional penalties unless there was disclosure as well as a "strong" opinion supporting the validity of the transaction, The Joint Committee study in July also proposed a definition of tax shelter, and would provide a "reasonable cause" abatement of penalty only with disclosure coupled with an opinion concluding a 75% likelihood of success, but also proposed to expand the "aiding and abetting" penalty to the issuer of such a 75% likelihood opinion if a "reasonable tax practitioner" would not have issued such an opinion. Of these three approaches to "reasonable cause" opinions, we prefer the H.R.2255 approach which would prohibit the ability of corporate taxpayers to rely on such opinions.

As our Reports indicate, increased disclosure is an essential corollary to any of these increased penalty provisions. Disclosure will be helpful on several counts. First, proper disclosure will change the odds of the audit lottery, and the need to disclose will itself act as a deterrent. In addition, to the extent taxpayers actually

report, a disclosure regime will act as an early warning system to allow the Treasury and the Service to respond quickly to new developments on this front.

But more than disclosure is required. As we have noted, to address the insufficient deterrent effect of current law, we believe it important for Congress to adopt, as proposed in H.R.2255, a "strict liability" approach to the accuracy-related tax-shelter penalties by eliminating the reasonable cause exception to the imposition of the accuracy-related penalties for prescribed tax-motivated transactions.

We acknowledge a strict-liability approach to accuracy-related penalties will put considerable pressure on defining appropriate cases subject to the provision, and may increase significantly the leverage of Internal Revenue Service agents in some audits of corporate taxpayers. Because we believe it crucial to increase the risk associated with entering into corporate tax shelters, we have concluded that, on balance, it is acceptable to live with these effects of H.R.2255 when the imposition of the penalty (i) depends on the taxpayer's position ultimately not being sustained as a matter of current law, (ii) the amount of the penalty is reduced if the transaction is disclosed on the taxpayer's return, and (iii) the penalties are targeted at corporate tax shelters, as appropriately defined.

The critical element is therefore to define these suspect transactions in a manner that distinguishes artificial transactions designed to produce a tax benefit only, from legitimate corporate tax planning which we believe is clearly appropriate. Our report includes a definition of the type of transaction we believe should be subject to these penalties. Many of the elements of our proposal are also contained in H.R.2255 and we would be pleased to work with the Administration and Congress to clarify this approach and reconcile any differences.

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I will be pleased to answer your questions.

Chairman ARCHER. The Chair is grateful to all four of you for taking your time to come help us try to work our way through this very complicated process, and each one of you has an expertise from your own personal activities that can be very helpful to the Committee as we try to resolve this issue in the right way. So we do look forward to having your help as we work through this.

There are many, many questions that I guess can be asked and I will try to break the ice a little bit. And I am sure other members will want to add to that. I think all of us should agree with the basic foundation that we want to get at abusers and we don't want to get at people who are legitimate. How do we finally accomplish that?

Mr. Shewbridge, there was an allusion by some witnesses that the corporate tax base has been eroded by corporate tax shelters. And I am curious: Has the corporate tax base been eroded? What are the tax revenues coming from corporations in the aggregate today as compared to 5 years ago, for example, or 10 years ago?

Mr. SHEWBRIDGE. I really don't know what the absolute dollar amounts are. I have not seen any empirical data that suggests that corporate tax shelters are eroding the tax base. I did hear Ms. Paull's comments earlier on the Joint Committee's efforts to quantify how much certain transactions might involve after they worked their way through the legal system, but I cannot speak to their correctness.

Chairman ARCHER. Well, I should have directed this question to Mr. Talisman, and I overlooked doing that. But the Committee does need to have information as to what has actually happened to the revenues from corporations in the last 5 to 10 years.

Mr. SHEWBRIDGE. That has been one of our concerns. There really has not been any empirical data with respect to what is happening with respect to corporate tax shelters.

Chairman ARCHER. The preliminarily ad hoc information that I have as corporate tax revenues have gone up—and maybe other witnesses who will come before us today can testify to that.

I will ask you one other additional question. As a financial officer of a corporation, are you not under a fiduciary responsibility to keep your taxes as low as possible, as are legitimately related to your business transactions?

Mr. SHEWBRIDGE. Yes, I think I would say I am under requirement to pay only those taxes that I am absolutely required to under the law. And I think we do that to the best of our ability.

Chairman ARCHER. I hope we don't ignore that fiduciary responsibility as we go through this process, because taxes are a cost of doing business.

Mr. SHEWBRIDGE. Absolutely.

Chairman ARCHER. And legitimate operations can design their transactions in a way to keep their taxes as low as possible and/or under a fiduciary responsibility to do that, are they not?

Mr. SHEWBRIDGE. Yes, sir, they are. And I make no excuse for doing so.

Chairman ARCHER. Mr. Handler, I have got a couple more questions. In your opinion, will there be more or less litigation if this Doggett bill is enacted compared to current law?

Mr. HANDLER. I think as I say in my formal testimony with respect to the strict liability approach, that I think the Doggett bill proposes and that we endorse, I think there will be less litigation; and I think there will be less litigation because I think our corporate financial officers, such as Mr. Shewbridge, will know that the risk of entering any of these transactions will create a far greater penalty in terms of loss than the benefit that would be ultimately sustained by success. That would, I think, eliminate the frequency of these transactions, and I would hope eliminate litigation.

Chairman ARCHER. I assume, as both you and Mr. Sax will be retained by a number of people to advise them as to how to work their way through this process irrespective of what the legislative result is, and I don't want to imply that you may get more business because people will come to you and say, how in the world do we deal with all of these new vague tests and all of these very new reporting requirements and how can we be sure that we are safe and how can we know that we are not going to get into the penalty situation?

And I will put that aside for the moment as any possible special interest that you might have. But you certainly will be asked by your clients to defend them in the event that the IRS comes after them.

Mr. HANDLER. Absolutely.

Chairman ARCHER. That is your appropriate role, both you and Mr. Sax in our system. How would you argue on behalf of your client as to the definition of ″substantial″?

Mr. HANDLER. Well, that is obviously a relative term, and the litigation is only one aspect of the nature of the work that we do in New York and Mr. Sax and the ABA does nationwide. We rep-

resent—our organization has 3,000 tax professionals, and what is remarkable about the testimony that I have heard both here and at the Senate Finance Committee is that the professionals, the tax professionals, are cautioning Congress in the fact that they want more limitation imposed on the ability to deliver the kinds of opinions that are now being delivered.

I think we both are moving in that direction in different ways. That is one major element of what we as tax professionals do for a living. And what we are asking Congress to do is to give us some additional support in carefully analyzing transactions and describing the risks that are available to our corporate taxpaying clients. At the moment, as I said in my testimony, the risk at the moment is merely just additional interest, if the taxpayer loses and we have to advise the taxpayer of that, and when it comes time to litigation, the issue of substantial versus nonsubstantial is a function of the question of substantive law that might exist at that moment.

But what is remarkable is that our group and, I believe, Mr. Sax's group are basically asking for a further limitation on the kind of opinions that we would be asked, we are being asked to deliver today.

Chairman ARCHER. Well, is substantive law adequately specific to where you know what the term "substantial" means, or would you perhaps take a different position from the IRS?

Mr. HANDLER. Our view is that we don't——

Chairman ARCHER. Defending one of your clients.

Mr. HANDLER. I am sorry I thought you meant in terms of the litigation.

Chairman ARCHER. You won't defend the IRS, I don't think.

Mr. HANDLER. I am on the other sides of those issues.

Chairman ARCHER. Your involvement will be on behalf of the private client that is being contested by the IRS.

Mr. HANDLER. And I would argue——

Chairman ARCHER. How would you define on behalf of your client the term ″substantial″?

Mr. HANDLER. I would marshal all of the information that exists with respect to the transaction and try to demonstrate that the benefit that was achieved by the client as a business matter was substantial.

Chairman ARCHER. And is it possible the IRS would take a different position?

Mr. HANDLER. Yes, it is very possible, and that is what courts are for. The court would ultimately decide whether or not—which of us was right in that dispute.

Chairman ARCHER. Is it a precise term, or is it something that is going to always be left to the courts to make the subjective decision in every instance?

Mr. HANDLER. I don't think you can define ″substantial″ with precision. I think it has to be something which is the subject of ultimate dispute resolution.

Chairman ARCHER. That is the point I wanted to get at. Your job as shepherds and stewards of the Tax Code is to try to make it as specific as possible so that there will be a degree of certainty for the people in this country to know what they can and cannot do.

And I am a little bit concerned about what you have just told me compared to what your general testimony to this Committee was that you strongly support this. Because it will create clearly from your final answer a very nonspecific provision in the Code, which we already have tremendous problems with the IRS and the implementation of our system in these gray areas.

We find that our tax system in many instances is not determined by the law, but determined by the ability to negotiate. That is a bad tax system. No one taxpayer, because they have a better ability to negotiate with the IRS, should get a better result than another taxpayer in the very same situation. And now you are telling us this is an uncertain term, and there will be different results. That bothers me as someone who is trying to make the tax system more specific.

Now, let me ask Mr. Lifson. My colleague and friend, Mr. Doggett—and we are friends, we can disagree without losing our friendship——

Mr. LIFSON. Been there.

Chairman ARCHER. —and we do disagree significantly on a lot of issues—has said and has repeated today that people within your industry, and I suppose also, Mr. Sax, people within your profession, are sleazy, are underhanded, are hustlers. Do you know those people?

Mr. LIFSON. I suspect I do.

Chairman ARCHER. I don't think he is referring to anybody else. I think he is referring to consultants in either the CPA profession or the legal profession. And I am just curious if you know any of them.

Mr. LIFSON. Well, I am not sure I would use those words to describe them, but I could see why some people might use them. I don't have any as close associates, but I read about them the same way Mr. Doggett does.

Chairman ARCHER. Mr. Sax.

Mr. SAX. We have chosen quite deliberately not to employ those words in our descriptions.

Chairman ARCHER. So you don't know of any people in your profession that fit that description?

Mr. SAX. I wouldn't go so far as to say that, no.

Chairman ARCHER. Well, what percent would you say there are?

Mr. SAX. I would be pleased to respond to that. I am pleased to say that I believe it is very, very, very low, much lower than in the general population.

Chairman ARCHER. Oh, okay; 1 percent maybe?

Mr. SAX. I mean, I don't have statistical data, Mr. Chairman, of course, but I do——

Chairman ARCHER. Less than 10 percent?

Mr. SAX. I do take great pride in being a member of the bar. I take that honor and role as an officer of the court seriously. I believe on the whole, lawyers are very good people and try to take their mission seriously and do the right thing. And, yes, as with the general population and every other population, there will be bad apples.

Chairman ARCHER. Okay. I happen to be a lawyer myself, and I don't think it is a dishonorable profession. I agree with you, it is

an honorable profession; sometimes dishonored by some of our own members of the profession, but in itself an honorable profession. Why is it that the Bar Association, if it knows about sleazy, underhanded hustlers doesn't disbar them and solve the problem?

Mr. SAX. That is a very good question, Mr. Chairman. I think it arises principally from the fact that the organized bar is not very organized. It is balkanized into the bars of 50 States, often underfunded, often with very little by way of resources and very little ability to detect, much less punish the things that should be detected and punished.

Chairman ARCHER. Well, maybe we ought to try, you and I together ought to try shore up our association and see that it does a better job.

Mr. Lifson, what about the CPAs?

Mr. LIFSON. I think the road from accusation to conviction is a very long road indeed in all professions. And I do know that the AICPA is investigating and is continuously investigating various acts of bad behavior, including involvement with tax shelters. And it will continue to do so.

Chairman ARCHER. Mr. Doggett said in his testimony that one of your members, one of the Big 5, according to his testimony, requires its very smart staffers to come up with at least one economically stupid, but taxwise corporate tax dodge idea per week. Which one would that be?

Mr. LIFSON. I am not exactly sure, since I come here representing 40,000 practice units and 330,000 CPAs. So if one of those 40,000 practice units in fact does do that, then that would be something or that would be a matter for study. But I have a feeling that is a matter of characterization of activity rather than reality in the way that activities really work in that firm or any other firm.

Chairman ARCHER. Okay. Let me go back over what he said; he did not say one of the 40,000, he said one of the Big 5. Which one would that be?

Mr. LIFSON. I can't say for sure. I don't know.

Chairman ARCHER. Okay. Do you have any sort of intimation as to which one it might be?

Mr. LIFSON. I don't know.

Chairman ARCHER. And if so, would your association be willing to take action against them?

Mr. LIFSON. If, in fact, anybody had those sort of policies, one would first have to determine whether that was a person's policy or a firm's policy. I am sure that this is a much more complicated issue than the surface of the headline or the surface of an accusation.

Chairman ARCHER. Do you believe that is possible? I mean, this is just an allegation obviously, but do you believe it is possible?

Mr. LIFSON. I am a very open-minded person, I believe anything is possible.

Chairman ARCHER. Okay, I thank the gentleman for enduring my questioning.

Mr. Doggett.

Mr. DOGGETT. Thank you, Mr. Chairman.

Mr. Shewbridge, it is my understanding from your testimony that while we might have a different perspective on what belongs in legislation to address this problem, that you agree that the Congress should take legislative steps to address this problem; is that correct?

Mr. SHEWBRIDGE. Well, I really think it is a little bit broader than that. Some action in legislation may be needed, but it needs to be done in concert with additional enforcement, effective use of the tools that are already available to the IRS, and more faster guidance from the Treasury Department.

Mr. DOGGETT. I thank you for that.

And, Mr. Lifson, I understand the same to be true with reference to your testimony. You think it would be a mistake for this Congress not to act legislatively to address this problem, though you have a different view than I do about what the most appropriate legislative action is?

Mr. LIFSON. I think it would be fair to say we do not think it would be inappropriate to act.

Mr. DOGGETT. Do you think that the Congress needs to address this problem legislatively or not?

Mr. LIFSON. I believe in many respects the problem may well, through publicity and enhanced enforcement, solve itself; but the speed with which the problem may be solved may be of concern to this Congress.

Mr. DOGGETT. Giving the brevity of the questioning period I have, I would ask if you would submit to the Committee if you are aware of your association having ever disciplined or removed or barred any member or any individual accountant for peddling any type of corporate tax shelter. With reference to your comment that no one likes to see the tax system scammed, I agree with you, and certainly some of the tax shelters that you know have subsequently been outlawed were scamming the system, weren't they?

[The information follows:]

February 15, 2000

The Honorable Lloyd Doggett
328 Cannon Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Congressman Doggett:

This letter responds to your request at the House Ways and Means Committee hearings on November 10, 1999 for information about AICPA sanctions against members involved in "corporate tax shelters." As we stated at the hearings, we are determined to maintain the highest ethical standards for our members, and the AICPA and the state CPA societies participating in the Joint Ethics Enforcement Program are committed to protecting the public interest. The AICPA supports efforts to curtail "abusive tax shelters," and our only concern about legislation in this area is that it be carefully crafted to avoid both burdensome disclosure requirements and harsh penalties for average taxpayers with normal transactions.

Our Professional Ethics Division investigates each allegation of unprofessional or unethical conduct by an AICPA member that is brought to its attention by another AICPA member, a state CPA society, a client, a member of the public, or any other source. We are proactive in obtaining such information, and monitor media reports, including local and national newspapers, professional publications, and government reports. Many of our investigations are based on referrals received from government agencies, and we review the IRS Internal Revenue Bulletin for sanctions imposed by the IRS Director of Practice. We encourage IRS and other government officials to report individuals involved in abusive conduct to help us maintain the high standards of our profession.

All sanctions involving suspension or expulsion from membership, and guilty findings of the Joint Trial Board are published in The CPA Letter which is broadly distributed, including to all 338,000 AICPA members, state CPA licensing boards, various government agencies, various trade and consumer publications, and others. We are also in the process of providing this information on the AICPA's website. In addition to affecting the reputation of the CPA involved, distribution to state licensing boards could potentially result in the loss of his or her license to practice. We take these matters very seriously, as do our members.

During the five-year period from 1994 through 1998, we investigated approximately 1,720 members, resulting in 258 being either suspended or expelled; 391 being given letters of required corrective action; and 60 being disciplined by the Joint Trial Board. While these cases include members who have an alleged involvement with a tax scam or fraud, we are not able to tell you specifically how many of these are related to "corporate tax shelter" issues. The AICPA Professional Ethics Division is developing a new database that will be able to capture the type of information you have requested in the future, but our present system is over ten years old and does not allow us to search in the way you have requested. Also, the term "corporate tax shelter" has yet to be well-defined, and has only been used in the sense that you have used it since the end of 1998. The statistics for 1999 have not yet been compiled, but they will be derived from the present database system.

I hope this information is helpful, and would be happy to provide any follow-up information.

Sincerely,

DAVID A. LIFSON
Chair
AICPA Tax Executive Committee

Mr. LIFSON. I am not sure what the definition of a tax shelter is, but there certainly are some arrangements.

Mr. DOGGETT. How about the renting of Swiss Town Hall and renting it right back; wasn't that scamming the system?

Mr. LIFSON. Yes, it is, but I just am not sure about what a tax shelter is.

Mr. DOGGETT. Thank you.

Mr. Handler, isn't the calculation that is contemplated in the HR 2255, as I proposed it, essentially the same calculation that a corporation that you might represent would have to make in deciding whether to buy one of these tax shelter products that some hustler calls them with a cold call and says they ought to undertake?

Mr. HANDLER. I am not sure I understand what you mean by ″calculation,″ Congressman, but——

Mr. DOGGETT. In deciding whether the tax shelter product is worth getting, whether it exposes them to too much risk, whether they will have any real gain or whether they will have tremendous tax advantages with no real risk.

Mr. HANDLER. I think the typical analysis that is done, appropriately done, in making corporate decisions of these types, is what is a risk-reward analysis; what do I gain by taking—by doing a transaction, what do I risk by doing it?

Mr. DOGGETT. Isn't that essentially what the economic substance test calls for?

Mr. HANDLER. Yes.

Mr. DOGGETT. It is a little more complicated than that, I know.

Mr. HANDLER. It is a quite a bit more complicated, but it is basically the same series of equations in terms of deciding whether it is a worthwhile transaction to undertake.

Mr. DOGGETT. Do I understand your testimony to be that there is a limit, as important as it is to have precision in the Code so you can advise your client what the law is, there is some limit as to how far that precision can go and it is necessary to have certain terms like ″substantial″ and ″meaningful,″ and this is not the only part of the Internal Revenue Code where we find them, isn't it?

Mr. HANDLER. That is true.

Mr. DOGGETT. Mr. Sax, I want to commend you and Mr. Handler. I think your statement is to be praised, not only for its succinct eloquence, but for the fact it takes a certain amount of courage for you and Mr. Handler and other members of the bar to come to this Committee. After all, the same corporations that are being tempted with these cold calls and these tax hustlers are the same people that are the clients of many of your members. And I think it does take courage to come forward and speak out about the need to resolve this issue.

Now, I know you might not use the same terminology that I do about this. But when you see the cover of Forbes Magazine about tax shelter hustlers, and you hear about these problems from the 20,000 members of your profession, are there good people in some cases doing bad things because of the pressure of tax hustlers? And in addition, let me just ask you to respond to the point in my testimony earlier that I had a multinational major Texas company come and tell me that their tax department was getting about one cold call a day with some tax shelter proposal.

Does that fit with what you have been hearing about this problem?

Mr. SAX. Yes, it does, Congressman. We do agree that we are confronting a situation of good people doing bad things. We have tried to address that portion of the issue that we can directly deal with within the bar, by proposing the amendment to Circular 230 to upgrade the quality of tax opinion-giving, figuring that is one thing we can do immediately, and we have sought to do that.

Mr. DOGGETT. But that by itself won't get the job done, as your testimony indicates?

Mr. SAX. That is absolutely correct.

Mr. DOGGETT. Could you just—we have all talked—I have used the Swiss Town Hall example. But can you give us an example that won't cause our eyes to glaze over, of what some of these corporate tax shelters that you are hearing about, what they basically involve?

Mr. SAX. There is a side of me that says I can't give you an example that won't cause your eyes——

Mr. DOGGETT. That is part of the problem, isn't it? They are so complex no one can understand them.

Mr. SAX. One of the common denominators is complexity used to obfuscate.

Mr. DOGGETT. Exactly.

Mr. SAX. You often hear it said that no agent can ever understand or unravel this. So one of the predicates is the complexity that makes it almost impossible for me to give you a short description of one. One fundamental concept is to bring a built-in loss in from offshore and marry it up with a gain that is about to happen

onshore, using either a partnership or corporation to mix the two up.

Now, that is not done in a few words, that is done in several hundred pages of documents. That is the gist of one type.

Mr. DOGGETT. By offshore, you mean some foreign entity that is not subject to United States taxation, they get the gain or the income, but the loss is here to be a benefit to someone who is a U.S. taxpayer?

Mr. SAX. That's correct, Congressman. And the fundamental of that is to take a transaction that has a gain side and a loss side and put the gain side in a place that doesn't pay tax, whether it is a domestic nontaxpayer, a domestic taxpayer with offsetting losses or a foreign taxpayer, and put the loss side in the hands of someone who will use it to reduce taxes in this country.

Mr. DOGGETT. I thank all four of you.

Chairman ARCHER. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Gentlemen, I appreciate the testimony that all of you have provided. And I have heard from others before the Committee today that basically while there are tools that the IRS has to use today to combat illegal tax shelters, you think that there is more that is needed legislatively to give the IRS or the government better tools to fight this kind of activity.

And I am not sure how much further we need to go to give more tools to the government. But assuming that we do need to give more tools, do any of you see a danger in going too far the other way, in terms of inhibiting legitimate economic activity? I know you are not economists, but you have some familiarity with what we are talking about. Do any of you have any fears of that?

Mr. SAX. Congressman, I can respond to that by saying that we are very concerned about inhibiting legitimate business activity, and it is for that reason that we have confined the essence of our proposal to disclosure, figuring that if the worst thing that can happen is that facts have to be disclosed by the taxpayer, that is not too terrible. That is an acceptable burden to place on taxpayers who come close to the line.

Mr. LIFSON. I think that my statement emphasizes the importance, not of law enforcement, but of self-assessment. And by making large gray areas, areas that responsible corporate officers must disclose, a responsible corporate officer knows the difference between a business start-up that produces losses and a tax shelter. They know what they have been working with and how they have worked and generated those numbers. So by having that gray area simply disclosed with higher standards and so on, you create a self-policing system.

Mr. MCCRERY. Mr. Shewbridge, how do you respond to that?

Mr. SHEWBRIDGE. I don't disagree at all with the disclosure proposals. The books and records of corporate taxpayers, and their tax returns are open, and I don't think they mind disclosing.

I would say, though, that with respect to corporate tax shelters, the only way that we can disclose is to know what the animal is. We need a very clear, concise definition of what a corporate tax shelter is in order to know what to disclose. Also, we think that the promoters ought to be disclosing.

Mr. MCCRERY. Mr. Handler.

Mr. HANDLER. Mr. McCrery, in the report I referred to in my testimony, we have a great concern about legitimate corporate transactions being subject to this kind of legislation. And in fact one of the things we comment on in our report is that we do not agree with what has been called by Mr. Lifson and others as super 269 provisions or new substantive rules that would potentially attract corporate transactions. We believe, as others on this panel do, that disclosure is one element; but we also believe, as I said earlier, that the reasonable cause opinion which does not allow for significant risks to a corporate taxpayer who wishes to undertake one of these transactions has got to be strengthened.

Mr. MCCRERY. In 1997, the Congress enhanced the substantial understatement penalty related to corporate tax shelters. Given the standard lag in the audit cycle, should we wait to assess the impact of that change in the law on this kind of activity, or do you think it is going to have any substantial impact?

Mr. SHEWBRIDGE. I think you are seeing some activity in that right now, with many recent court decisions. Taxpayers are certainly going to be looking at those cases and making decisions as to what risks they want to take going forward. So, yes, I think a waiting period is probably in order.

Mr. MCCRERY. Anybody else?

Mr. HANDLER. As Ms. Paull said earlier in the earlier panel, one of the problems with the existing understatement penalty is the ability to avoid it. And it is relatively easy to avoid in today's world by reason of the kinds of opinions I have discussed. I think it would be appropriate for Congress to consider that element of the understatement regime.

Mr. MCCRERY. And one last question, especially for you, Mr. Handler, in your testimony, you say that you favor increasing penalties on taxpayers that are engaging in corporate tax shelters. Would you also favor increasing penalties on advisers who issue opinions to corporate tax shelters, to corporate tax executives on tax shelters?

Mr. HANDLER. At the risk of sounding self-serving, our view is that the proper party to whom these penalties should apply is the taxpayer undertaking them. In my experience, with the members of my group, and we represent, remember, 3,000 professionals, the issue of proper analysis and the kinds of risks that are associated with these transactions is a function of what the law requires.

At the moment, the law only requires a more likely than not opinion, which, because of the ambiguity of some provisions in the laws, is a relatively easy standard to satisfy. That is why we proposed strict liability and allow professionals like myself to advise clients that there is a risk of penalty in transactions where a properly-defined tax shelter might fit this particular transaction.

Mr. MCCRERY. I want to thank you. I am a lawyer, too. And I appreciate Mr. Sax defending our profession. I know a lot of lawyers and I know some of them who are good and some of them who are bad. I know a lot of doctors, some of them are good and some are bad. I know a lot of lobbyists, most of them are good.

But, you know, I am tired of this name calling and trying to classify people according to their profession or according to somebody's

perception of them. I wish we would get away from that. There are good people and bad people in all professions and I think generally about the same percentage in all the professions are good and bad. And we ought to just accept that and move on.

Thank you, gentlemen.

Chairman ARCHER. Would my friend from Louisiana include Members of Congress in that?

Mr. MCCRERY. Yes, sir.

Chairman ARCHER. Gentlemen, I would like to follow up for just a moment, if I may, because we do want to work through this and we do want to find the right answer. I myself believe it is important that we have as much specificity as possible in the standard that we ultimately enact.

And I am very, very concerned about that. But this entire concept is promoted, in a sense, by allusion to promoters and those who call you on the phone, those who come to your office, those who are going to charge you a fee because they have got a tax shelter plan and they are going to urge you to adopt it. And clearly, I don't think any of us are sympathetic to that.

And if there is a way to ferret that out and address that, then that is something we ought to try to pursue, if possible. But as I read this bill, it goes far beyond that. I mean, the promotion of the bill is on the basis that there are outside promoters coming in and that they are—they are literally prospering on the tax system by getting good people to do wrong.

But the reality of this bill is, it is far, far more than that. It is anybody who undertakes any deduction, any deduction, any tax credit, internally generated, because you are under the fiduciary responsibility to reduce your tax burden legally as much as you can as a cost of doing business. It hits you, not just the promoters, not just people who come in from the outside.

And I am concerned about that, particularly when there is not a specificity as to standard, because I think it gets over into everything, it gets over into your borrowing, it gets over into the underwriting of new stock issues, the investment brokerage houses. Every aspect that has any relationship to the Tax Code is covered by this in a very broad sweeping way. And so we need your help to help us work through this and to get to the right answer.

I am curious before you leave, I would like to know what each of you feels—we have listened to you and I think we have an understanding of where you are. But what I want to hear is whether any one of you endorses H.R. 2255, the Doggett bill that we are having a hearing on today.

Does any one of you endorse that bill and that approach specifically to the problem?

Mr. HANDLER. Mr. Chairman, as I indicate in my testimony, our group endorses the repeal of the reasonable cause exception to the understatement penalty. And that is a key provision of the Doggett bill.

Chairman ARCHER. But it goes far beyond that.

Mr. HANDLER. I agree it goes far beyond it.

Chairman ARCHER. So the record should show that there is not a one of you that endorses the complete H.R. 2255?

Mr. SAX. That is true, Mr. Chairman, but the disclosure provisions of H.R. 2255 and our disclosure provisions are for all practical purposes the same, so we very much endorse and embrace the disclosure provisions of that section of the bill.

Chairman ARCHER. But let me reiterate, this bill goes far beyond the provision that you endorse and the provision that Mr. Handler endorses, so if the Committee's decision must be to embrace this bill or to embrace nothing, what would be your position in its entirety now? You know, I don't mean to pick and choose one section. You say, okay, I agree with this section, you have got to look at the bill in its entirety.

Mr. HANDLER. May I speak to that for a second?

Chairman ARCHER. Yes, please, sir.

Mr. HANDLER. Someone earlier at one of the—perhaps it was yourself indicated there are many approaches to this issue and many ways of getting at a solution to these problems. Provisions in the Doggett bill, including the definition of a noneconomic attribute, pick up and include a number of items that we would include in a different form of approach to the problem in trying to define transactions that would be subject to a nonstrict liability penalty.

In that respect, I think that the Doggett bill is absolutely correct. It has picked up a number of the attributes of the tax shelter proposals that are floating around, not all of them, but many of them, the taxing different party issues and the other aspects, which I believe and our group believes should be included in an appropriate definition of a tax shelter to which strict liability would apply.

Now, that is not the same approach as Congressman Doggett's approach. We do not agree with a substantive provision that is like a 216 or a super 269, which is akin to what Congressman Doggett approach would provide. But that doesn't mean that we disagree with the elements of the Congressman's proposal.

Chairman ARCHER. Thank you for explaining that.

Mr. Doggett, do you want to follow up?

Mr. DOGGETT. Since my name is invoked, I do want to follow up just a little bit.

Mr. Sax, let me begin with you. I believe you made clear that as far as this bill, which only has about 4 or 5 sections, section 4 on disclosure, you believe follows almost verbatim the recommendations that the ABA has made?

Mr. SAX. That is correct.

Mr. DOGGETT. With reference to section 3, while I understand you don't embrace section 3 as it is written today, the idea of having the courts rely on a codified economic substance rule, which your section has not yet proposed with specificity, but that idea is something that we share in common with reference to section 3, is it not?

Mr. SAX. There is a commonality.

Mr. DOGGETT. And there is a difference?

Mr. SAX. And there is a difference. We propose that where the courts choose to apply to the economic substance doctrine there be a weighing of tax and nontax benefits. I might note that we don't view that as complicating matters. As the economic substance doctrine stands, there is no standard whatever and it is very com-

plicated because there is simply no guidance. Adding the word "substantial" is imperfect but it is better than nothing at all, and certainly clearer.

Mr. DOGGETT. If the word "substantial" is used in the right way, it adds more clarification than our current law has?

Mr. SAX. That is our position.

Mr. DOGGETT. And Mr. Handler, I believe the New York State Bar Association disclosure provisions are somewhat different than the American Bar Association's disclosure requirements, is there some variation?

Mr. HANDLER. We are very close.

Mr. DOGGETT. Very close. So as to the disclosure requirements and the provisions concerning the reliance on what is called the "excuse letter," you are in agreement with the bill?

Mr. HANDLER. Yes, absolutely.

Mr. DOGGETT. And is your position somewhat similar to Mr. Sax's with reference to the use of the economic substance test; you believe that the Congress should codify it, but you would do that in a somewhat different way than I have done in section 3?

Mr. HANDLER. That is correct.

Mr. DOGGETT. And generally the findings and purpose clause, which is section 2, it seems to me to read pretty close to some of the testimony as you have given here.

Mr. HANDLER. That is correct, Congressman.

Mr. DOGGETT. Thank you very much for your testimony.

Chairman ARCHER. Gentlemen, again, thank you. And we will be looking forward to having further input from you as we move through this process. Thank you very much.

Mr. SAX. Thank you.

Mr. HANDLER. Thank you.

Mr. LIFSON. Thank you.

Chairman ARCHER. Our next panel, Mr. Kenneth Kies, Mr. David Hariton, Mr. Martin Sullivan, and Mr. Danny Carpenter. Please come to the witness table.

Welcome, gentlemen. As usual, your entire written statement, without objection, will be inserted in the record. And if you will make your verbal testimony as concise as possible, the Committee would appreciate it.

And if each of you will identify yourself and the entity that you represent before giving your testimony, that will be good for the record.

Mr. Kies, would you begin?

STATEMENT OF KENNETH J. KIES, CO-MANAGING PARTNER, WASHINGTON NATIONAL TAX SERVICES, PRICEWATERHOUSECOOPERS LLP

Mr. KIES. Yes, Mr. Chairman, and thank you, I am Ken Kies, co-managing partner of PricewaterhouseCoopers, Washington tax practice. The U.S. and Canadian tax practice of the worldwide firm has more than 6,500 professionals.

Today I would like to focus my comments on what I believe to be specific myths surrounding the debate over corporate tax shelters. Also I have submitted extensive written testimony that I appreciate the Chairman including in the record.

The first myth I would like to discuss concerns corporate revenues. Advocates of sweeping change will tell you that corporate tax shelters are eroding the corporate tax base. There is no evidence that supports this view. Yet the Treasury Department and others continue to cite an unsubstantiated claim by Joseph Bankman, a part-time teacher at Stanford University, that $10 million in tax revenues are lost each year from corporate tax shelter activities.

Mr. Bankman is not an economist and has had limited experience with tax issues in private practice. He tells us in his Internet chat room that this $10 billion figure is and, I quote, "obviously just an estimate." Yet this $10 billion figure keeps being repeated by government officials as if it was somewhat a fact or the result of an authoritative study; it is not.

The facts are as follows, as reflected on the charts in front of you. First, corporate income tax revenues since 1992 have grown by more than 80 percent. By contrast, the economy has grown by only 44 percent. Second, corporate income tax revenues over the past 4 years have been at the highest levels as a percentage of GDP than at any time since 1980. These statistics suggests an extremely vibrant corporate income tax, not a system being eroded.

Myth number 2 is that the corporate tax shelter proposals advanced by Treasury Department and others would not hinder legitimate business transactions. Treasury's John Talisman in a letter to Mr. Doggett has stated that the shelter proposals would not unduly interfere with legitimate transactions. Frankly, it is not okay to interfere with legitimate transactions. In reality, the shelter proposals would cast considerable doubt on the continued legality of a wide range of legitimate transactions.

The UK earlier this year abandoned a proposal very similar to the corporate tax shelter proposals before us because of concerns over the uncertainties that proposals would have created for UK corporations seeking to move forward with legitimate transactions.

You should also look to the U.S.-Italy income tax treaty. As proposed, this new treaty included a so-called main purpose test that would have given tax administrators the authority to disregard the tax rules as written, if they believed tax reduction was a motivation behind a transaction.

In other words, this test looks a lot like the definitions of a corporate tax shelter before us. The Joint Committee in testimony this month rightfully criticized this treaty provision, calling the main purpose test vague and subjective and noting that it can, and I quote, "create planning difficulties for legitimate business transactions." Precisely the same arguments apply to the corporate tax shelter proposals before us. The Senate has now stripped this test from the Italian treaty.

Myth number 3 is that the IRS lacks sufficient tools under law to combat abuse; a string of recent court victories by the IRS directly refutes this argument.

Myth number 4 is that new disclosure requirements would not be burdensome. The broad disclosure requirements proposed would force corporate taxpayers to generate mountains of paperwork describing a multitude of transactions. The UK abandoned its proposed legislation in significant part due to concerns over the ability to handle the extensive disclosure that would have been required.

Myth number 5 is that a consensus has somehow formed around new policies to address perceived shelters. The fact is that there are considerable differences of opinion. The Joint Committee does not support Treasury's proposed expansion of section 269. Moreover, Treasury itself isn't sure what the right answer is. Treasury's July "white paper," released just before the July 4th recess, made significant modifications to the shelter proposals included in the administration's own budget released just months earlier. This uncertainty over policy throws into question the remaining proposals that Treasury continues to promote.

In closing, I would simply say that proponents of sweeping corporate tax shelter legislation have not met the burden of proof necessary to justify enactment of changes as sweeping and radical as the proposals before us. The fact of the matter is that corporate taxes are inherently complex, as are corporate transactions themselves, and the relationship between the IRS and taxpayers is naturally adversarial. As a result, there are going to be differences of opinion over application of the tax law. These realities will not be changed by the proposals before us.

Before I close, I would like to say that we at PricewaterhouseCoopers take very seriously our professional responsibility as tax advisers. We are concerned about the perception that has arisen that corporate tax planning is growing increasingly abusive. We do not believe abuses are pervasive; however, we do believe there are practitioners who engage in questionable activities. We believe this calls for a targeted and measured response.

Toward this end, we commend the Joint Committee for its proposal to strengthen Circular 230 and regulations that govern the professional conduct of tax practitioners. We are prepared to work with the tax-writing Committees in considering this issue. And I thank you very much for your time.

Chairman ARCHER. Thank you, Mr. Kies, and you carefully prepared your remarks to finish exactly at the 5-minute level.

[The prepared statement follows:]

Statement of Kenneth J. Kies, Co-Managing Partner, Washington National Tax Services, PricewaterhouseCoopers, LLP

I. INTRODUCTION

PricewaterhouseCoopers appreciates the opportunity to submit this written testimony to the Committee on Ways and Means on the subject of "corporate tax shelters."

PricewaterhouseCoopers, the world's largest professional services organization, provides a full range of business advisory services to corporations and other clients, including audit, accounting, and tax consulting. The firm, which has more than 6,500 tax professionals in the United States and Canada, works closely with thousands of corporate clients worldwide, including most of the companies comprising the Fortune 500. These comments reflect the collective experiences of many of our corporate clients.

Doing something about "corporate tax shelters" has a certain rhetorical appeal, stoked by the press, that threatens to overwhelm principles of sound tax policy and administration. Concerns have been expressed that large corporations routinely are avoiding taxes by undertaking complex tax-motivated transactions. The Treasury Department and others claim—without supporting evidence—that the corporate income tax base is eroding and will continue to erode absent sweeping tax-law changes and new restrictions on corporate tax executives.

In this testimony, we provide a detailed, reasoned analysis of the asserted "corporate tax shelter" problem and the proposed remedies, taking into account actual experiences of corporate taxpayers rather than theoretical speculation. We analyze

budget and economic data to determine whether there is empirical evidence supporting the view that the corporate income tax base is being eviscerated. We explore the efficacy of tools already available to the Treasury Department and the Internal Revenue Service (IRS)—and to the Congress—to address abusive transactions. Finally, we consider the potential impact of proposals that have been advanced to date by Treasury[1], the staff of the Joint Committee on Taxation (JCT)[2], and others.

We conclude that no justification has been presented that would support enactment of such sweeping tax policy changes at this time. Economic data does not suggest any systemic erosion of the corporate income tax base. Current-law administrative tools, if used properly, are more than adequate to detect and penalize tax avoidance. The legislative proposals that have been advanced are at odds with sound tax policy principles and administration, would threaten legitimate tax-planning activities undertaken by corporate tax professionals, and would exacerbate the complexity of the tax code.

II. Arguments Against Sweeping Changes

A. The Myth of the Eroding Corporate Income Tax Base

Both the Treasury Department and the JCT staff have cited as justification for their proposals a possible erosion of corporate income tax revenues attributable to "corporate tax shelters." Neither has presented any evidence to support this concern. Rather, both have cited—as their only reference—statements made Joseph Bankman of Stanford University that corporate tax shelters are responsible for $10 billion in lost corporate income tax revenues each year. Bankman essentially admits he has no data supporting his $10 billion figure in his Internet tax policy chatroom,[3] where he answers a question from a reader as to the references for his $10 billion figure as follows: "The $10 billion figure that I am quoted on is obviously just an estimate." This unsubstantiated claim hardly represents the type of serious economic analysis that should be undertaken before adopting sweeping tax policy changes of the scope envisioned by Treasury and the JCT staff.

An analysis of actual data shows no evidence of a loss of corporate income tax revenues attributable to shelter activities. Since 1992, corporate federal income tax payments have grown by more than 80 percent, from $100.3 billion in fiscal 1992 to $184.7 billion in fiscal 1999 (see Appendix 1). By point of comparison, GDP has grown by 44 percent over this period. Over the fiscal 1993–1999 period, corporate tax payments averaged 2.1 percent of GDP; only once in the preceding 1980–1992 period were corporate income tax payments higher in percentage terms (in 1980).

Despite the high level of tax payments in the post–1992 period, some commentators have pointed to a two-percent drop in federal corporate tax payments in fiscal 1999, as compared to the prior year, as possibly indicating corporate tax shelter activity.[4] This claim has been made despite the fact that, at 2.1 percent of GDP in fiscal 1999 (through June), corporate tax payments remain higher than the average for the 1980–1999 period (1.9 percent).

A possible explanation for this drop is a relative decline in corporate profits attributable to depreciation deductions associated with increased equipment investment and the increase in employee compensation relative to corporate profits.[5] The Congressional Budget Office in its mid-session review in July noted these as among the factors putting downward pressure on corporate profits.[6] It also should be noted that the slight falloff in corporate profits was not unforeseen—the Office of Management and Budget (OMB) at the beginning of this year projected that corporate income tax payments would fall in FY 1999, before rising again in FY 2000.[7] It should

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[1] The Problem of Corporate Tax Shelters, Department of the Treasury, July 1999; General Explanations of the Administration's Revenue Proposals, Department of the Treasury, February 1999.

[2] Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters), Staff of the Joint Committee on Taxation, July 22, 1999 (JCS–3–99) [hereinafter JCT study].

[3] http://www.law.nyu.edu/bankmanj/federalincometax

[4] See, Martin A Sullivan, "Despite September Surge, Corporate Tax Receipts Fall Short," 85 Tax Notes 565 (Nov. 1, 1999).

[5] See, New York Times, September 21, 1999, "When an Expense is Not an Expense." This article points to rising compensation paid in the form of stock options as a possible explanation. An increase in employee compensation increases personal income tax (at the employee level) at the expense of corporate income tax, because employee compensation generally is deductible in computing corporate income tax and includable in computing personal income tax.

[6] Congressional Budget Office, The Economic and Budget Outlook: An Update, July 1, 1999.

[7] The Administration's FY 2000 budget projected that corporate income revenues would total $182.2 billion in FY 1999, or $2.5 billion less than actual.

be further noted that actual corporate income tax payments for FY 1999 exceeded the January forecast by more than $2 billion.

In this section of the statement, we examine whether the recent dip in corporate income tax payments provides any evidence that "corporate tax shelter" activity is proliferating. After a thorough review of the data, including data from the IRS, the Bureau of Economic Analysis (BEA), and corporate financial statements, we find no basis for assertions that increased shelter activity has caused corporate tax burdens to fall.

1. Corporate tax liability and the timing of tax payments

Corporate tax payments received by the IRS during a given year fail to reflect that year's tax liability for several reasons. First, large corporate taxpayers frequently have five to ten "open" years for which final tax liability has not been determined. Thus, current corporate tax payments may include deficiencies (plus interest and penalties) for a number of prior tax years. Similarly, current corporate tax payments may be reduced by refunds arising from overpayments of corporate tax in a number of prior tax years. In addition, current tax payments may be reduced by previously unused net operating losses and tax credits that are carried forward from prior years. Thus, current data on corporate income tax payments received by the IRS are not a reliable indicator of current year tax liability; rather, current year tax receipts reflect a blend of current and past year tax liabilities, and are reduced by carryforwards of unused losses and credits from prior years.

Corporate tax payments

Monthly information on receipts of corporate income taxes by the U.S. Government is published by the Financial Management Service of the U.S. Treasury Department.[8] The Treasury defines net corporate receipts in any month as gross receipts less refunds. Net corporate tax receipts were $185 billion in calendar year 1998, and are estimated to remain flat (at $184.6 billion) in 1999, based on annualized results for the first nine months (see Appendix 2). Gross corporate tax receipts in 1998 were $213.5 billion, and based on the first nine months of 1999, gross receipts are estimated to increase by more than one percent to $216.4 billion. The slight dip in net corporate receipts over the last two years is almost entirely due to an increase in refunds. Refunds can increase as a result of overpayments of estimated tax (which may occur when profits turn out to be lower than expected) or as a result of amendments to prior year tax returns (for example, when current year losses or credits are carried back to a prior tax year). Until the IRS tabulates tax return data for 1998 and 1999, it is not possible to determine the reason for the recent increase in refunds.

Corporate tax liability

For purposes of the National Income and Product Accounts, BEA makes current estimates of corporate tax liability based on IRS and other data. The IRS calculates annual corporate income tax liability by tabulating corporate tax returns (before audit). The most recent publicly available corporate income tax return information is for IRS years 1996 (i.e., tax years ending after June 1996 and before July 1997).[9]

In summary, it is important to distinguish between corporate tax liability and corporate tax receipts. Because corporate tax receipts are a mix of estimated tax payments for the current year as well as adjustments (both up and down) to taxes paid with respect to prior years, a drop in corporate tax receipts does not imply a drop in corporate tax liability. For example, in 1985, corporate tax receipts increased over the prior year at the same time that corporate tax liability decreased (see Appendix 2).

2. Effective Tax Rates: Commerce Department Data

Corporate tax liability can be broken down into two components: (1) a reference measure of profits arising in the corporate sector; multiplied by (2) the effective tax rate (which is equal to corporate tax divided by reference profits). A decline in corporate tax liability can occur as a result of lower profits or, alternatively, as a result of a lower effective tax rate. A decline in corporate tax liability due to a fall in real corporate income is not, of course, evidence of tax shelter activity. By contrast, a decline in the effective tax rate may warrant investigation to determine if there is tax avoidance not intended by lawmakers.

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[8] U.S. Dept. of the Treasury, Monthly Treasury Statement of Receipts and Outlays of the United States Government.

[9] See, IRS, Statistics of Income Bulletin, Winter 1998/1999.

Calculation of the effective corporate tax rate requires a measure of corporate income tax liability as well as a reference measure of corporate profits. Two data sources are used in this analysis: (1) the National Income and Product Accounts (NIPA) published by the U.S. Commerce Department; and (2) data from audited financial statements of public companies filed with the Securities and Exchange Commission (SEC) on Form 10K. Effective tax rate calculations based on NIPA data are described in this section; calculations based on SEC data are described in the following section.

One of the items used by BEA to calculate GDP is "corporate profits before tax."[10] This concept of profits includes income earned in the United States (whether by U.S. or foreign corporations) and excludes income earned outside the United States. For purposes of calculating an effective tax rate, several adjustments are made to "corporate profits before tax": (1) profits of the Federal Reserve Banks are subtracted; (2) profits of subchapter S corporations are subtracted; (3) payments of State and local income tax are subtracted; and (4) corporate capital gains are added. These adjustments follow the methodology developed by CBO to estimate "taxable corporate profits."[11] BEA estimates that corporate profits before tax, as adjusted, increased from $587 billion in calendar 1998 to $603 billion in 1999 (see Appendix 3).[12] As a percent of GDP, pre-tax corporate profits are estimated to have reached a post–1980 high of 7.0 percent in 1996, with a dip to 6.9 percent in 1997–1998, and a further dip to 6.8 percent in the first half of calendar 1999 on an annualized basis.

Based on adjusted NIPA data, the effective corporate tax rate, measured as federal corporate tax liability divided by corporate profits before federal income tax, is projected to be 32.7 percent in 1999, higher than the 31.2 percent rate in 1998 and higher than the 32.6 percent average for the 1993–1999 period (see Appendix 3). Thus, based on the National Income and Product Accounts, there is no evidence of a decline in the effective rate of corporate income tax.

3. Effective Tax Rates: SEC Data

Corporate effective tax rates also can be estimated from the audited financial statements that publicly traded companies are required to file with the SEC. This method was used by the General Accounting Office in its 1992 study of corporate effective tax rates.[13] Following the GAO methodology, the effective corporate tax rate is measured by dividing the current provision for federal income tax into reported U.S. operating income, reduced by the current provision for State and local income tax. U.S. operating income is determined by subtracting foreign operating income from total operating income net of depreciation, based on geographic segment reporting.

Standard & Poors publishes SEC 10K data in its Compustat database, which is updated monthly.[14] Based on the August 1999 Compustat data release, effective corporate tax rates were calculated for the 1988–1998 period using information from every corporation in the database that supplied all of the necessary data items. Recognizing that the results for 1998 might not be comparable to prior years due to the limited sample size, the effective tax rates for 1996 and 1997 were recomputed using information from the same companies as in the 1998 sample.

For purposes of this analysis we excluded publicly traded corporations and partnerships that are not generally taxable at the corporate level (i.e., mutual funds and real estate investment trusts). Separate calculations were made for companies that reported foreign activity (multinationals) and for companies that reported no foreign

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[10] BEA makes two adjustments to this measure of corporate profits in determining GDP: (1) BEA uses an "economic" measure of depreciation rather than tax depreciation (i.e., the "capital consumption adjustment"); and (2) BEA removes inventory profits attributable to changes in price (i.e., the "inventory valuation adjustment").

[11] See, Congressional Budget Office, The Shortfall in Corporate Tax Receipts Since the Tax Reform Act of 1986, CBO Papers, May 1992. The first adjustment reflects the fact that the Federal Reserve system is not subject to corporate income tax; the second adjustment is made because S corporations generally do not pay corporate level tax (rather the income is flowed through to the shareholders); the third adjustment is made because state and local income taxes are deductible in computing federal income tax; and the fourth adjustment is necessary because corporations are taxed on capital gains while GDP excludes capital gains.

[12] 1999 data are annualized based on the first six months of the year, seasonally adjusted.

[13] See, General Accounting Office, "1988 and 1989 Company Effective Tax Rates Higher Than in Prior Years," GAO/GGD–92–11, August 1992.

[14] Financial statements for companies with fiscal years ending after May of 1998, and before June of 1999, are classified as 1998 statements in Compustat. Because there is a lag between the end of a company's fiscal year and the time it files Form 10K, and another lag between the time the form is filed and the time it is processed by Standard & Poors, information for Compustat's 1998 year was incomplete as of August 1999.

activity (domestics). A multinational's current provision for U.S. tax may include U.S. tax on foreign source income; consequently, measured relative to domestic income, the effective tax rate of U.S. multinationals may be higher than for comparable domestic firms. In theory, U.S. tax on foreign source income should be removed from the numerator of a domestic effective tax rate calculation; however, this adjustment cannot accurately be made with financial statement data.

The results of this analysis are shown in Appendix 4. For 1997, the most recent year for which annual reporting is complete, companies included in the Compustat sample report $78 billion of current federal income tax liability, accounting for over 40 percent of federal corporate tax liability in the National Income and Product Accounts. The Compustat sample of firms excludes private companies and public companies that do not report all of the items necessary to calculate the effective tax rate. While the average firm in Compustat is much larger than the average corporate taxpayer, the main purpose of our analysis is to examine the trend in effective corporate tax rates over time. We have no reason to believe that there is a systematic difference in trend effective tax rates between companies in Compustat and other corporate taxpayers. Indeed, if there were a proliferation of corporate tax shelter activity, we might expect to see indications of this first among the largest and most sophisticated corporations, of the type included in the Compustat sample.

In general, we find that the effective tax rates calculated from financial statement data are lower than those calculated from the National Income and Product Accounts. One reason for this is that the profit definition used for the NIPA calculations is based on tax depreciation, while the profit definition used for the financial statement calculations is based on book depreciation. Another reason is that the income element of nonqualified stock options is deductible for tax purposes when the option is excercised (and included in the employee's income), but is not treated as an expense against income for financial statement purposes. We also find that, on average, over the 1988–1998 period, effective federal tax rates are higher for multinational corporation than for domestic corporations.

Based on financial statement data, the corporate effective tax rate for all corporations (domestic and multinational) was higher in 1997 (19.9 percent) than the average over the ten-year period 1988–1997 (18.5) percent, and for the sample of companies reporting financial results for 1998, the effective tax rate increased between 1997 (19.4 percent) and 1998 (20.7 percent).[15]

In summary, based on audited financial statements, there is no evidence for a decline in the effective corporate tax rate. This is consistent with our findings using National Income and Product Account data.

4. Corporate capital gains

One category of corporate "tax shelter" that has received recent attention is the use of transactions designed to avoid tax on capital gains. Indeed, one commentator believes these transactions are so prevalent that the tax on corporate capital gains has essentially been rendered "elective."[16] If this assessment of the corporate income tax system were accurate, we would expect to see a marked decline in corporate capital gain realizations in recent years.

The IRS data, however, do not support the view that corporations easily can avoid tax on capital gains. Excluding mutual funds, net corporate gain on capital assets increased by 54 percent from $53 billion in 1992 to $82 billion in 1996 (the most recent year for which IRS data is available)—an average annual increase of 11.5 percent per year (see Appendix 5). In short, notices of the death of the corporate capital gains tax are premature.

5. Conclusion

If unusually high levels of corporate tax shelter activity have been occurring over the last few years, we would expect to see a drop in corporate tax liability relative to normative measures of pre-tax corporate income. To test this hypothesis, we measure corporate effective tax rates using data from the National Income and Product Accounts and audited financial statements. Neither measure shows a suspicious drop in tax liabilities relative to corporate income; to the contrary, both measures show flat or rising corporate effective tax rates over the last five years. Moreover, if corporate capital gains tax was easily avoidable using tax shelter techniques, we would expect to see little or no growth in net capital gains reported on

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[15] These results also generally hold up when effective tax rates are measured relative to U.S. assets or U.S. revenues. Among domestic-only firms, however, income has grown more slowly than either assets or revenues since 1995, with the result that the ratio of tax liability to either assets or revenues has declined slightly for companies without foreign operations.

[16] Michael Schler, as quoted in the September 1, 1999, Wall Street Journal "Tax Report," A1.

corporate tax returns. Again, the data disprove this hypothesis, showing instead a robust rate of increase over the most recent four-year period for which data are available.

B. Efficacy of Current-Law Tools

Proponents of extensive new legislation to address "corporate tax shelters" overlook the formidable array of tools currently available to the government to deter and attack transactions considered as abusive. In our view, the tools described below are more than sufficient to achieve compliance with the corporate income tax. That is, these tools enable the IRS and courts to ensure that corporations pay the corporate income tax liability that results from application of the Internal Revenue Code.

1. Threat of penalties

As an initial matter, the tax Code includes significant disincentives to engage in potentially abusive behavior. Present law imposes 20-percent accuracy-related penalties under section 6662 in the case of negligence, substantial understatements of tax liability, and certain other cases. In considering a proposed transaction that may turn on a debatable reading of the tax law, a corporate tax executive must weigh the potential for imposition of these penalties, which could have a negative impact on shareholder value and on the corporation.

Furthermore, it should be noted that Congress, in the 1997 Taxpayer Relief Act, strengthened the substantial understatement penalty as it applies to "tax shelters." Under this change, which was supported and encouraged by the Treasury Department, an entity, plan, or arrangement is treated as a tax shelter if it has tax avoidance or evasion as just one of its significant purposes.[17] The Congress believed that this change, coupled with new reporting requirements that Treasury has failed to activate, would "improve compliance by discouraging taxpayers from entering into questionable transactions."[18] Although this change is effective for current transactions, the IRS and Treasury have not yet issued regulations providing guidance on the term "significant purpose."

The 1997 Act changes have made it even more important for chief tax executives to weigh carefully the risks of penalties and even more difficult to determine which transactions might trigger penalties. At this time, there is no demonstrated justification for making these penalties even harsher.

2. Anti-abuse rules

The Code includes numerous provisions that arm Treasury and the IRS with broad authority to prevent tax avoidance, to reallocate income and deductions, to deny tax benefits, and to ensure taxpayers clearly report income.

These rules long have provided powerful ammunition for challenging tax avoidance transactions. For example, section 482 authorizes the IRS to reallocate income, deductions, credits, or allowances between controlled taxpayers to prevent evasion of taxes or to clearly reflect income. While much attention has been focused in recent years on the application of section 482 in the international context, section 482 also applies broadly in purely domestic situations. Further, the IRS also has the authority to disregard a taxpayer's method of accounting if it does not clearly reflect income under section 446(b).

In the partnership context, the IRS has issued regulations under subchapter K aimed at arrangements the IRS considers as abusive.[19] The IRS states that these rules authorize it to disregard the existence of a partnership, to adjust a partnership's methods of accounting, to reallocate items of income, gain, loss, deduction, or credit, or otherwise to adjust a partnership's or partner's tax treatment in situations where a transaction meets the literal requirements of a statutory or regulatory provision, but where the IRS believes the results are inconsistent with the intent of the Code's partnership tax rules.

The IRS also has issued a series of far-reaching anti-abuse rules under its legislative grant of regulatory authority in the consolidated return area. For example, under Treas. Reg. Sec. 1.1502–20, a parent corporation is severely limited in its ability to deduct any loss on the sale of a consolidated subsidiary's stock. The consolidated return investment basis adjustment rules also contain an anti-avoidance rule.[20] The rule provides that the IRS may make adjustments "as necessary" if a

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[17] Section 6662(d)(2)(C)(iii). Prior law defined tax shelter activity as an entity, plan, or arrangement only if it had tax avoidance or evasion as the principal purpose.

[18] General Explanation of Tax Legislation Enacted in 1997, Staff of the Joint Committee on Taxation, December 17, 1997 (JCS 23–97).

[19] Treas. Reg. § 1.701–2.

[20] Treas. Reg. § 1.1502–32(e).

person acts with "a principal purpose" of avoiding the requirements of the consolidated return rules. The consolidated return rules feature several other anti-abuse rules as well.[21]

3. Common-law doctrines

Pursuant to several "common-law" tax doctrines, Treasury and the IRS can challenge a taxpayer's treatment of a transaction if they believe the treatment is inconsistent with statutory rules and the underlying Congressional intent. For example, these doctrines may be invoked where the IRS believes that (1) the taxpayer has sought to circumvent statutory requirements by casting the transaction in a form designed to disguise its substance, (2) the taxpayer has divided the transaction into separate steps that have little or no independent life or rationale, (3) the taxpayer has engaged in "trafficking" in tax attributes, or (4) the taxpayer improperly has accelerated deductions or deferred income recognition.

These broadly applicable doctrines—known as the business purpose doctrine, the substance over form doctrine, the step transaction doctrine, and the sham transaction and economic substance doctrine—give the IRS considerable leeway to recast transactions based on economic substance, to treat apparently separate steps as one transaction, and to disregard transactions that lack business purpose or economic substance. Recent applications of those doctrines have demonstrated their effectiveness and cast doubt on Treasury's asserted need for additional tools.

The recent decisions in *ACM v. Commissioner*[22] and *ASA Investerings v. Commissioner*[23] illustrate the continuing force of these long-standing judicial doctrines. In *ACM*, the Third Circuit, affirming the Tax Court, relied on the sham transaction and economic substance doctrines to disallow losses generated by a partnership's purchase and resale of notes. The Tax Court similarly invoked those doctrines in *ASA Investerings* to disallow losses on the purchase and resale of private placement notes. Both cases involved complex, highly sophisticated transactions, yet the IRS successfully used common-law principles to prevent the taxpayers from realizing tax benefits from the transactions.

More recent examples of use of common-law doctrines by the IRS are the Tax Court's decisions in *United Parcel Service v. Commissioner*[24] (8/9/99), *Compaq Computer Corp. v. Commissioner*[25] (9/21/99), and *Winn-Dixie v. Commissioner*[26] (10/19/99). In *United Parcel Service*, the court agreed with the IRS's position that the arrangement at issue—involving the taxpayer, a third-party U.S. insurance company acting as an intermediary, and an offshore company acting as a reinsurer—lacked business purpose and economic substance. In *Compaq*, the court agreed with the IRS's contention that the taxpayer's purchase and resale of certain financial instruments lacked economic substance and imposed accuracy-related penalties under section 6662(a). In *Winn-Dixie*, the court held that an employer's leveraged corporate-owned life insurance program lacked business purpose and economic substance.

This recent line of cases and the IRS's increasingly successful use of common-law doctrines in these cases argue against any need for expanding the IRS's tools at this time or, as the Treasury Department has suggested, codifying such doctrines.

4. Treasury action

Treasury on numerous occasions has issued IRS Notices stating an intention to publish regulations that would preclude favorable tax treatment for certain transactions. Thus, a Notice allows the government (assuming that the particular action is within Treasury's rulemaking authority) to move quickly, without having to await development of the regulations themselves—often a time-consuming process—that provide more detailed rules concerning a particular transaction.

Recent examples of the use of this authority include Notice 97–21, in which the IRS addressed multiple-party financing transactions that used a special type of preferred stock; Notice 95–53, in which the IRS addressed the tax consequences of "lease strip" or "stripping transactions" separating income from deductions; and No-

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[21] E.g., Treas. Reg. § 1.1502–13(h) (anti-avoidance rules with respect to the intercompany transaction provisions) and Treas. Reg. § 1.1502–17(c) (anti-avoidance rules with respect to the consolidated return accounting methods).
[22] 157 F.3d 231 (3d Cir. 1998). See also Saba Partnership, T.C.M. 1999–359 (10/27/99).
[23] T.C.M. 1998–305.
[24] T.C.M. 1999–268.
[25] 113. T.C. No. 17.
[26] 113. T.C. No. 21.

tices 94–46 and 94–93, addressing so-called "corporate inversion" transactions viewed as avoiding the 1986 Act's repeal of the *General Utilities* doctrine.[27]

Moreover, section 7805(b) of the Code expressly gives the IRS authority to issue regulations that have retroactive effect "to prevent abuse." Although many Notices have set the date of Notice issuance as the effective date for forthcoming regulations,[28] Treasury has used its authority to announce regulations that would be effective for periods prior to the date the Notice was issued.[29] Alternatively, Treasury in Notices has announced that it will rely on existing law to challenge abusive transactions that already have occurred.[30]

5. Targeted legislation

To the extent that Treasury and the IRS may lack rulemaking or administrative authority to challenge a particular type of transaction, one other highly effective avenue remains open—that is, enactment of legislation. In this regard, over the past 30 years dozens upon dozens of changes to the tax code have been enacted to address perceived abuses. For example, earlier this year Congress enacted legislation (H.R. 435) addressing "basis-shifting" transactions involving transfers of assets subject to liabilities under section 357(c).

These targeted legislative changes often have immediate, or even retroactive, application. The section 357(c) provision, for example, was made effective for transfers on or after October 19, 1998—the date House Ways and Means Committee Chairman Bill Archer introduced the proposal in the form of legislation. Chairman Archer took this action, in part, to stop these transactions earlier than would have been accomplished under the effective date originally proposed by Treasury (the date of enactment).

C. Adverse Impact of Proposals

The Treasury, JCT staff, and similar proposals addressing "corporate tax shelters" would impose additional uncertainty and burdens on corporate tax executives. As discussed below, each turns on a vague and subjective definition of "corporate tax shelter" that would threaten to sweep in legitimate transactions undertaken in the ordinary course of business, such as financing transactions, capital restructuring transactions, corporate reorganizations, and other transactions. Businesses already are confronted by a complicated, ever-changing, and in many instances, arcane and outdated tax system comprised of an intricate jumble of statutes, case law, regulations, rulings, and administrative procedural requirements. Rather than providing clearer and more precise rules defining transactions viewed as abusive, the proposals would add new layers of complexity and uncertainty.[31]

Some commentators have suggested that the broad sweep of the "corporate tax shelter" proposals can be justified as representing a balance between "objective" rules and "flexible" concepts to ensure appropriate behavior by corporations. We disagree, believing that the vast majority of corporations abide by rules of appropriate planning and that the extremely broad and vague concepts introduced by the proposals severely would hamper legitimate business planning. Faced with the regime of draconian sanctions proposed by Treasury and the JCT staff, taxpayers would find it difficult to make business decisions with any certainty as to the tax consequences. This would be particularly true since classification as a "tax shelter" could result not from taking an incorrect position under the tax code, but merely because "significant" tax benefits resulted from certain vaguely defined types of arrangements.

Like individual taxpayers,[32] corporations have the right legitimately to seek minimization of tax liabilities, i.e., to pay no more in taxes than the tax law demands.

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[27] The General Utilities doctrine generally provided for nonrecognition of gain or loss on a corporation's distribution of property to its shareholders with respect to their stock. See, General Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935). The General Utilities doctrine was repealed in 1986 out of concern that the doctrine tended to undermine the application of the corporate-level income tax. H.R. Rep. No. 426, 99th Cong., 1st Sess. 282 (1985).

[28] See, e.g., Notice 95–53, 1995–2 CB 334, and Notice 89–37, 1989–1 CB 679.

[29] See, e.g., Notice 97–21, 1997–1 CB 407.

[30] Notice 96–39, I.R.B. 1996–32.

[31] Treasury Department Acting Assistant Secretary (Tax Policy) Jonathan Talisman, in an October 4 letter to Rep. Lloyd Doggett (D–TX) states that the Administration's proposals would not "unduly" interfere with legitimate business transactions.

[32] Individual taxpayers often undertake actions to obtain favorable tax treatment, but this alone is not considered a reason simply to disallow the benefits. For example, an individual holding an appreciated security may decide to hold it for sale until a particular date solely to obtain long-term capital gain treatment. Also, an individual may take out a home-equity loan to pay off credit-card debt because interest on the home loan can be tax deductible. As another

Indeed, corporate executives have a fiduciary duty to preserve and increase the value of a corporation for its shareholders. Some commentators decry this responsibility, termed "profit center activity" in current management parlance, as wrong. We disagree. Responsible minimization of taxes in conjunction with the business activity of a corporation is one important function of corporate executives seeking to enhance profitability, and one that long has been viewed as consistent with sound policy objectives.[33]

In a broad sense, the proposals overlook the significant responsibilities shouldered by corporate tax executives in collecting and remitting corporate income taxes, withholding taxes, and an array of excise taxes.[34] In addition to these duties as a significant private administrator of the U.S. tax code, a chief corporate tax executive must understand management's business decisions and planning objectives, and provide reasoned advice to management on the tax consequences of various possible business decisions and on appropriate ways to minimize tax liabilities. Once these business decisions are made, the tax executive must implement them by supervising the formation of applicable entities, creating systems for capturing tax-related information as it is generated from the business, and implementing procedures for the calculation and remittance of taxes, information returns, and additional documentation necessary for compliance. The collective effect of the Treasury and JCT staff "shelter" proposals would be to penalize these responsible tax executives by adding to their burden and increasing complexity and uncertainty in determining the tax consequences of business decisions.

Ironically, the proposed "corporate tax shelter" definitions strongly resemble a test included in the new U.S.-Italy Income Tax Treaty and the new U.S.-Slovenia Income Tax Treaty that drew strong criticism from the JCT staff. "Main purpose" tests in the proposed treaties would have denied treaty benefits (e.g., reduced withholding rates on dividends) if the main purpose of a taxpayer's transaction is to take advantage of treaty benefits. The JCT staff correctly raised policy objections to this proposed test:

> The new main purpose tests in the proposed treaty present several issues. The tests are subjective, vague and add uncertainty to the treaty. It is unclear how the provisions are to be applied. . . . This uncertainty can create planning difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty. . . . This is a subjective standard, dependent on the intent of the taxpayer, that is difficult to evaluate. . . . It is also unclear how the rule would be administered. . . . In any event, it may be difficult for a U.S. company to evaluate whether its transaction may be subject to Italian main purpose standards.[35]

The Senate approved these treaties on November 5. In light of concerns raised by the JCT staff and the Senate Foreign Relations Committee, the Senate approved the treaties subject to a "reservation" that has the effect of eliminating the "main purpose" test.

These very same objections—"vague," "subjective," "difficulties for legitimate business transactions"—have been raised by businesses with respect to the Treasury's and the JCT staff's "corporate tax shelter" proposals. Any distinction between the "main purpose" test and the "corporate tax shelter" tests is extremely fine. Like the "main purpose" test, these proposals would give tax administrators broad authority to disregard the application of written rules where they believe they see tax considerations playing too important a role in structuring transactions.

D. Worldwide Experience with Anti-Avoidance Rules

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example, an individual renting a home may decide to purchase it, viewing the tax benefits as a principal purpose for entering into the transaction. In such cases, Congress has not been concerned that the taxpayer acted out of tax motivations; the tax benefits still are allowed.

[33] Judge Learned Hand wrote: "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions." Comm'r v. Newman, 159 F.2d 848, 850–851 (2d Cir. 1946) (dissenting opinion).

[34] Of the $1.7 trillion in tax revenue collected by the federal government in FY 1998, corporations either remitted directly or withheld and remitted more than 50 percent, vastly reducing the compliance burden on the IRS and individuals.

[35] "Explanation of Proposed Income Tax Treaty and Proposed Protocol between the United States and the Italian Republic," October 8, 1999 (JCS–9–99); see also, "Testimony of the Staff of the Joint Committee on Taxation before the Senate Committee on Foreign Relations Hearing on Tax Treaties and Protocols with Eight Countries," October 27, 1999 (JCX–76–99).

Recent experiments with "anti-avoidance" tax legislation undertaken by other major industrialized countries provide useful case histories for U.S. policymakers contemplating the Treasury and JCT staff proposals.

Sweden

Sweden repealed its "general anti-avoidance rule" (GAAR) in 1993 following "some dissatisfaction with its performance."[36]

Canada

Canada in 1988 adopted a GAAR disregarding transactions resulting in reductions of tax unless the transaction is carried out primarily for non-tax purposes. Regarding the practical impact of the Canadian GAAR, one commentator has noted that "very few transactions that would have been carried out before the introduction of the rule have not been carried out since its introduction."[37] While withholding final judgment on the GAAR, the commentator has noted that "the courts could make the rule into an overly broad weapon that discourages legitimate commercial activity."[38] This commentator also notes that the Canadian GAAR was enacted after the Canadian Supreme Court had rejected judicial approaches to fighting tax-avoidance—this absence of judicial activism is hardly the case in the United States, as the recent ACM, United Parcel Service, and Winn-Dixie decisions clearly show. As one observer has noted, in the United States, "robust judicial doctrines have served in the place of a GAAR."[39]

Australia

Australia reinstituted a GAAR in 1981, following the failure of earlier GAAR provision. The new GAAR continued to draw criticism. As one commentator has noted, "If we are concerned about the philosophical questions as to the rule of law in a complex society and not just about revenue collection, we should as a result have concerns about the present GAAR operative in Australia."[40]

United Kingdom

The United Kingdom's recent experience with a GAAR is particularly noteworthy. In the 1997 Labor Party budget submission, U.K. Chancellor of the Exchequer Gordon Brown proposed creation of a GAAR to counter perceived tax avoidance in the corporate sector. The U.K. Inland Revenue was directed to review this area and consider how such a GAAR might be framed.

A "consultative document"[41] published by Inland Revenue in October 1998 provided a rough draft for a GAAR. Inland Revenue would be given authority to ignore "tax-driven transactions" or to substitute the tax results that would have been produced by a "normal" commercial transaction. A "tax-driven transaction" would be defined as a transaction one of whose main purposes is "tax avoidance." "Tax avoidance" would defined as:[42]

> (a) not paying tax, paying less tax, or paying later than would otherwise be the case,
>
> (b) obtaining repayment or increased repayment of tax, or obtaining repayment earlier than would otherwise be the case, or
>
> (c) obtaining payment or increased payment by way of tax credit, or obtaining such payment earlier than would otherwise be the case.

The draft plan also discussed a safe harbor for "acceptable tax planning," which Inland Revenue sketchily defined as "arranging one's affairs so as to avoid tax in a way that does not conflict with or defeat the purpose of the legislation."

Businesses responded that the proposal, with its lack of any objective test, would raise significant uncertainties over the tax treatment of transactions undertaken in the normal course of business. The draft plan itself envisioned that taxpayers would need some sort of quick "clearance," before undertaking a transaction, that Inland

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[36] Graeme S. Cooper, Tax Avoidance and the Rule of Law, IBFD Publications BV, 1997, p. 10.

[37] Brian Arnold, "The Canadian General Anti-Avoidance Rule," Tax Avoidance and the Rule of Law, ed. Graeme S. Cooper, IBFD Publications BV, 1997, p. 241.

[38] Ibid. p. 244.

[39] Cooper, supra p. 10.

[40] Jeffrey Waincymer, "The Australian Tax Avoidance Experience and Responses: A Critical Review," Tax Avoidance and the Rule of Law, ed. Graeme S. Cooper, IBFD Publications BV, 1997, p. 306.

[41] "A General Anti-Avoidance Rule for Direct Taxes: Consultative Document," U.K. Inland Revenue, October 1998.

[42] Id., at 6.5.2.

Revenue would not seek to apply the GAAR to the transaction. However, following issuance of the draft, concerns mounted at Inland Revenue that the agency might lack the resources to process clearance applications on a timely basis. In light of problems that had been identified calling into question whether a GAAR could work in practice, Chancellor Brown in March 1999 announced that the U.K. government would not be proceeding with plans to implement the GAAR.

The U.K. experience with the GAAR proposal parallels the current U.S. "corporate tax shelter" proposals. Both initiatives would rely on subjective terminology and would give broad discretion to the taxing authorities, raising concerns from the business sector that legitimate transactions would be affected. For U.S. policymakers, the U.K. experience with the GAAR presents a clear picture of the dangers and difficulties associated with overly broad anti-avoidance rules. As with the U.K. experience, the IRS would not be able to provide effective and timely advance approval of a multitude of transactions submitted for clearance; also taxpayers would incur substantial costs in applying for approval.

We respectfully urge Congress to reach the same conclusion regarding Treasury's and the JCT staff proposals that prudent decisionmakers in the United Kingdom ultimately reached in rejecting the GAAR proposal.

III. Analysis of "Corporate Tax Shelter" Proposals

A. Treasury Department Proposals

The Treasury Department's "corporate tax shelter" proposals were advanced in the Administration's FY 2000 budget and revised in a "White Paper" published July 1, 1999.[43] The following are brief summaries of the Treasury proposals as revised, followed by our comments:[44]

1. Disallowance of tax benefits

Summary

The proposal would disallow deductions, credits, exclusions, or other allowances obtained in a "tax avoidance transaction." This would be defined generally as any transaction in which the reasonably expected pre-tax profit of the transaction is insignificant relative to the reasonably expected net tax benefits of such transaction. The proposal also would deny tax benefits associated with financing transactions where the benefits are in excess of the economic return of the counterparty to the transaction.

Comment

The proposal would expand the current-law section 269 rules to deny deductions or other tax allowances flowing from a "tax avoidance transaction," an entirely new and vague concept. While the first prong of Treasury's definition of this term is styled as an objective test, the inclusion of subjective or unexplained concepts in the equation precludes such a characterization. The proposal raises significant questions of policy and practicality. As an initial matter, what constitutes the "transaction" for purposes of this test? Next, what are the parameters for "reasonable expectation" in terms of both pre-tax economic profit and tax benefits? Further, where is the line drawn regarding the significance of the reasonably expected pre-tax economic profit relative to the reasonably expected net tax benefits?

Under this ill-defined proposal, even though a taxpayer's transaction may have economic substance and legitimate business purpose, the tax savings could be denied to the taxpayer if another route of achieving the same end result would have resulted in the remittance of more tax. The proposed expansion of section 269 would create uncertainty for corporate taxpayers that engage in prudent tax planning to implement business objectives.

2. Substantial understatement penalty

Summary

The substantial understatement penalty imposed on corporate tax shelter items generally would be increased to 40 percent (reduced to 20 percent if the taxpayer

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[43] Treasury dropped proposals to eliminate completely the reasonable cause exception in the case of "corporate tax shelters," to disallow deductions for fees paid to tax shelter promoters and advisors, and to impose a 25-percent excise tax on tax benefits subject to rescission or insurance provisions.

[44] These comments supplement analysis provided in testimony presented by PricewaterhouseCoopers in conjunction with the House Ways and Means Committee's March 10, 1999, hearing on the revenue proposals in the Administration's FY 2000 budget.

satisfies certain disclosure requirements). The reasonable cause exception would be retained, but narrowed with respect to transactions deemed to constitute a corporate tax shelter—for these transactions, taxpayers would have to have a "strong" probability of success on the merits and to meet disclosure requirements. A "corporate tax shelter" would be defined as any arrangement (to be determined based on all the facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction.

Comment

This proposal is overbroad, unnecessary, and inconsistent with the goals of rationalizing penalty administration and reducing taxpayer burdens. Here again, the penalty would introduce the vague concept of "tax avoidance transaction."

Second, sharp restrictions on the reasonable cause exception would result in situations where a revenue agent may feel compelled to impose a punitive 40-percent penalty even though the agent determines that (1) there is substantial authority supporting the return position taken by the taxpayer, and (2) the taxpayer reasonably believed (based, for example, on the opinion or advice of a qualified tax professional) that its tax treatment of the item was more likely than not the proper treatment. It is doubtful that agents would accept a taxpayer's argument against application of the penalty based on having had a "strong probability of success," an undefined term setting an unrealistically high threshold.

Rather than serving as a deterrent to undertaking questionable transactions, the virtually automatic proposed penalty would penalize—at a harsh 40-percent rate—taxpayers for entering into arrangements that they reasonably believed to be proper and supported by substantial authority.

3. Disclosure

Summary

The Treasury proposal would require disclosure of transactions that have a combination of "some" of the following characteristics: a book/tax difference in excess of a certain amount; a rescission clause, an unwind provision, or insurance or similar arrangement for the anticipated tax benefits; involvement with a tax-indifferent party; advisor fees in excess of a certain amount or contingent fees; a confidentiality arrangement; and the offering of the transaction to multiple corporations.

Disclosure would be required of corporations and promoters. Corporations entering into transactions having these characteristics would be required to file a disclosure form with the IRS National Office by the due date of the tax return for the taxable year for which the transaction is entered into. The corporation also would have to attach the form to all tax returns to which the transaction applies. Promoters would be required to file the disclosure form within 30 days of offering the transaction.

The form would require information regarding the transaction characteristics discussed above and the nature and business or economic objective of the transaction. For corporations, it would have to be signed by a corporate officer who has knowledge of the factual underpinnings of the transaction for which disclosure is required; the officer would be "personally liable" for misstatements on the form. The corporation would not be required to file the form if it had specific knowledge that the promoter had disclosed the transaction. A "significant" monetary penalty would apply for failure to disclose.

Taxpayers also would be required to disclose on the return transactions reported differently from their form if the tax benefits exceed a certain threshold amount.

Comment

This proposal represents another example of Treasury overreaction aimed at perceived "shelter" transactions, imposing further burdens on corporate taxpayers. The existing tax shelter registration rules—which Treasury has yet to implement—and the existing penalties provide Treasury with ample tools to address situations of perceived abuse.

This proposal would create considerable uncertainties for taxpayers determining whether disclosure is required. Consider, for example, the requirement to disclose transactions that are reported differently from their form. Does "form" refer to the label given to the transaction or instrument, or does it refer to the rights and liabilities set forth in the documentation? For example, if an instrument is labeled debt, but has features in the documentation typically associated with an equity interest, is the form debt or equity? What if the taxpayer reasonably believed that it was reporting the transaction in accordance with its "form," but later interpretations of "form" suggested that it had not so reported the transaction?

It appears that the proposal would require disclosure for a number of other common and legitimate corporate business transactions. For example, the requirement to disclose transactions and arrangements with a significant book/tax difference would sweep in a wide range of non-abusive transactions. (See also our comments, below, on the JCT staff's disclosure requirements.)

4. Promoters

Summary

The proposal would impose a 25-percent excise tax on fees received in connection with promoting or rendering tax advice related to corporate tax shelters. Treasury also notes that an alternative might be to amend current-law penalties applicable to promoters and advisors under sections 6700, 6701, and 6703.

Comment

The imprecise definition of a corporate tax shelter transaction contained in this and related Treasury proposals would make it difficult for professional tax advisers to determine the circumstances under which this provision would apply. The substantive burdens of interpreting and complying with the statute and the administrative problems that taxpayers and the IRS would face cannot be overstated. The creation of the new excise tax would subject tax advisers to an entirely new and burdensome tax regime that again shifts the focus away from the substantive tax aspects of the transaction to unrelated definitional issues.

5. "Tax-indifferent" parties

Summary

Treasury would retain its proposal to tax income allocable to a "tax-indifferent" party with respect to a corporate tax shelter, but notes that certain modifications would be necessary to narrow the scope of its proposal.

Comment

Treasury itself now concedes that its proposal "may be difficult to administer and may only represent an additional penalty on the corporate participant (because the tax-indifferent party is not subject to U.S. taxing jurisdiction). . . ."[45]

This overreaching Treasury proposal cannot be justified on any tax policy grounds. The proposal ignores the fact that many businesses operating in the global economy are not U.S. taxpayers, and that in the global economy it is increasingly necessary and common for U.S. companies to enter into transactions with such entities. The fact that a tax-exempt person earns income that would be taxable if instead it had been earned by a taxable entity surely cannot in and of itself be viewed as objectionable.

Moreover, as it applies to foreign persons in particular, the proposal is overbroad in two significant respects. First, treating foreign persons as tax-indifferent ignores the fact that in many circumstances they may be subject to significant U.S. tax, either because they are subject to the withholding tax rules, because they are engaged in a U.S. trade or business, or because their income is taxable currently to their U.S. shareholders. Second, limiting the collection of the tax to parties other than treaty-protected foreign persons does not hide the fact that the tax-indifferent party tax would constitute a significant treaty override.

B. Joint Committee on Taxation Staff Recommendations

JCT staff proposals on "corporate tax shelters" were included in a 300-page study reviewing the interest and penalty provisions of the Code.[46] The following are brief summaries of the JCT staff proposals, followed by our comments:

1. Definition of "corporate tax shelter"

Summary

The JCT staff recommends "clarifying" the definition of a corporate tax shelter for purposes of the understatement penalty with the addition of several "tax shelter indicators." A partnership or other entity, a plan, or an arrangement would be considered (with respect to a corporate participant) to have a significant purpose of avoidance or evasion of federal income tax if it is described by at least one of the following indicators:

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[45] The Problem of Corporate Tax Shelters, supra n.1, at 114.
[46] 46. JCT study, supra, n.2.

• The reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected net tax benefits.

• q The arrangement involves a "tax-indifferent party," and the arrangement (1) results in taxable income materially in excess of economic income to the tax-indifferent participant, (2) permits a corporate participant to characterize items of income, gain, loss, deductions, or credits in a more favorable manner than it otherwise could without the involvement of the tax-indifferent participant, or (3) results in a noneconomic increase, creation, multiplication, or shifting of basis for the benefit of the corporate participant, and results in the recognition of income or gain that is not subject to federal income tax because the tax consequences are borne by the tax-indifferent party.

• The reasonably expected net tax benefits are significant, and the arrangement involves a tax indemnity or similar agreement for the benefit of the corporate participant other than a customary indemnity agreement in an acquisition or other business transaction entered into with a principal in the transaction.

• The reasonably expected net tax benefits are significant, and the arrangement is reasonably expected to create a "permanent difference" under GAAP.

• The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is designed so that the corporate participant incurs little (if any) additional economic risk as a result of entering into the arrangement.

Under the JCT staff proposal, an entity, plan, or arrangement still could be treated as a tax shelter even if it does not display any of the tax shelter indicators, provided that a significant purpose is the avoidance or evasion of federal income tax.

Comment

Rather than "clarify" the existing definition of a corporate tax shelter for purposes of the penalty, the JCT staff recommendation would layer on top of that already vague definition a test based on the existence of any one of five so-called "indicators"—each of which itself would introduce new, subjective tests. The first indicator, for example, would require the taxpayer (and the IRS) to analyze whether the "reasonably expected" pre-tax profit from a transaction is "insignificant" relative to the "reasonably expected" net tax benefits—and these determinations, in turn, must be based on "reasonable assumptions and determinations."

A multitude of common, legitimate corporate business transactions that do not have a significant purpose of tax avoidance nevertheless would be treated as corporate tax shelters if deemed to exhibit just one of the five "indicators." Conversely, even if an arrangement has no indicator of shelter status, it still could be treated as a shelter under the existing "significant purpose" definition. The five indicators raise a number of concerns and questions:

• The "profit vs. benefit" indicator, which uses such vague terms as "reasonably expected," "arrangement," and "insignificant," could taint as tax shelters many types of inherently risky corporate ventures, such as wildcat oil-drilling, basic research partnerships where profit projections necessarily are uncertain, and some real estate investments by REITs, as well as investments encouraged by the tax law that do not produce profits, such as cleanups of brownfield sites.

• The "tax-indifferent party" indicator ignores the fact that to compete in a global economy, U.S. businesses must engage in arrangements with foreign entities. Subjecting these transactions to an economic profit test would further complicate U.S. tax-law treatment of cross-border transactions.

• The "indemnity agreement" indicator would punish a corporation that prudently engages a tax practitioner to analyze a planned transaction where the practitioner is confident enough to stand behind the opinion with an indemnity or similar agreement.

• The "permanent difference" indicator could call into question transactions that the Code explicitly seeks to encourage, e.g., through augmented charitable deductions for certain contributions of inventory property, on the ground that there would be a permanent difference under GAAP.

• The "economic risk" indicator seems to taint ordinary business decisions as to operating structures as "shelter" activities merely because the business decision results in lower ultimate tax liability than alternative choices. These types of decisions, such as choosing a form of business or organizing tiers of subsidiaries, may not involve economic risk.

As a result of these layers of complexity, businesses and their tax advisors would be unable to determine with any confidence whether transactions entered into for strategic business reasons could trigger harsh penalties if later viewed as having either just one "indicator" of shelter status or a "significant" tax avoidance purpose. This problem would be aggravated by the JCT staff recommendation to eliminate the reasonable cause exception to the understatement penalty.

2. Substantial understatement penalty

Summary

The understatement penalty rate would be increased from 20 percent to 40 percent for any understatement that is attributable to a corporate tax shelter. The 40-percent penalty would be reduced to 20 percent if certain required disclosures are made, provided the taxpayer had substantial authority in support of its position. The JCT staff proposal also would eliminate the present-law reasonable cause exception and prohibit the IRS from waiving the penalty.

The 40-percent penalty could be abated completely if (1) the taxpayer establishes that it was at least 75 percent sure that its tax treatment would be sustained on the merits and (2) the taxpayer discloses certain information (discussed further below) that is certified by the chief financial officer or another senior corporate officer with knowledge of the facts.

A corporate participant that must pay an understatement penalty of at least $1 million in connection with a corporate tax shelter would be required to disclose the penalty payment to its shareholders, including the facts causing imposition of the penalty.

Comment

The stunning complexity of the JCT staff penalty recommendations can be seen in the JCT staff's own chart (attached hereto as Appendix 6) seeking to explain the various permutations and combinations of factors that can result in penalty rates of zero, 20 percent, and 40 percent.

The JCT staff recommendations include eliminating the present-law reasonable cause exception. Treasury itself already has backed away from its original proposal to eliminate the exception. The narrow abatement procedure proposed by JCT staff would be available only where a business could establish that it had been "highly confident" (75 percent) of prevailing in its position that any reliance on a third-party opinion was "reasonable," that no "unreasonable" assumptions were made in the opinion, and that the transaction had a "material" nontax business purpose. Thus, the new 40-percent penalty rate could apply (absent satisfying the proposed disclosure requirements) even if a taxpayer established that it had substantial authority for its position, that it had a greater than 50 percent (but not at least 75 percent) likelihood of prevailing, and that it had reasonable cause. It is unclear how a taxpayer would be able to support a 75-percent degree of confidence with respect to a transaction successfully challenged by the IRS. The JCT staff proposals are inconsistent with the acknowledged purpose of tax code penalties, namely, to encourage voluntary compliance by taxpayers rather than to serve as a punitive weapon wielded by the IRS.

The JCT staff recommendation that companies must disclose to shareholders payment of shelter penalties of $1 million or more—given the factors mentioned above—would be a highly inappropriate use of the tax statute. It is noteworthy that the proposal would require disclosure of a payment even if the company is challenging the penalty assessment in court.

3. Disclosure

Summary

For arrangements that are described by one of the "tax shelter indicators" and in which the expected net tax benefits are at least $1 million, corporations would have to satisfy certain disclosure requirements within 30 days of entering into the arrangement. This disclosure would have to include a summary of the relevant facts and assumptions, the expected net tax benefits, the applicability of any tax shelter indicator, the arrangement's analysis and legal rationale, the business purpose, and the existence of any contingent fee arrangements. The CFO or another senior corporate officer with knowledge of the facts would be required to certify, under penalties of perjury, that the disclosure statements are true, accurate, and complete.

Disclosure of tax shelter arrangements also would be required on the company's tax return, regardless of the amount of net tax benefits.

Comment

The recommended double disclosure requirements (at the time of the transaction and in the taxpayer's return) would be onerous and unnecessary. This flood of documents under the 30-day requirement would defeat the cited "early warning" purpose, since under the vague definitions of the proposal the IRS would receive so many documents it would have great difficulty processing and identifying those transactions it might want to examine. The proposed exceptions for certain arrange-

ments already reported on specific forms would apply only after regulations are issued—given that Treasury has yet to publish regulations under the 1997 tax shelter registration provision, the exceptions might never be triggered.

The breadth of the JCT staff's shelter recommendations can be seen by its statement that a mere purchase or sale of one asset, in and of itself, does not constitute an "arrangement." This statement is indicative of the overwhelming volume of guidance that would be necessary to implement and administer this proposal. These determinations would plunge businesses and their tax advisers deeper into an abyss of unfathomable terminology and complexity.

4. "Promoter" provisions

Summary

The JCT staff document includes a number of recommendations affecting other parties involved in "corporate tax shelters," including an expansion of the aiding and abetting penalty.

Comment

Having proposed a 75-percent likelihood-of-success threshold for avoiding the 40-percent penalty rate in certain situations—thereby virtually forcing businesses to obtain outside tax advice as to the proper treatment of transactions—the JCT staff recommendation next proposes imposing an "aiding and abetting" penalty on the practitioner giving the opinion if an understatement results and a so-called "reasonable practitioner" would have rendered a different opinion. No definition of a "reasonable practitioner" is provided.

The JCT staff proposal would allow the practitioner being penalized a "meaningful opportunity" to present evidence on his or her behalf. Should this evidence not sway the IRS, the practitioner would be penalized in an amount equal to the greater of $100,000 or one-half his or her fees, the practitioner's name would be published by the IRS, and the IRS would forward the practitioner's name to State licensing authorities "for possible disciplinary sanctions." These harsh provisions seem aimed at thwarting companies from seeking tax opinions as to the appropriate treatment of business transactions and arrangements, while also penalizing them if they do not.

5. Tax shelter registration requirements

Summary

The JCT staff recommends modifying the present-law rules regarding the registration of corporate tax shelters by (1) deleting the confidentiality requirement, (2) increasing the fee threshold from $100,000 to $1 million (in this respect, loosening the present-law requirement), and (3) expanding the scope of the registration requirement to cover any corporate tax shelter that is reasonably expected to be presented to more than one participant. Additional information reporting would be required with respect to arrangements covered by a tax shelter indicator.

Comment

The JCT staff recommendations would modify a legislative provision requiring registration that was enacted in 1997, but that has not become effective because Treasury has not issued implementing regulations. Before recommending further changes to the law relating to registration issues, Treasury should issue guidance on the existing registration requirements, which were enacted in 1997.

C. "Abusive Tax Shelter Shutdown Act of 1999"

Rep. Lloyd Doggett (D–TX) introduced on June 17, 1999, the "Abusive Tax Shelter Shutdown Act of 1999" (H.R. 2255), which includes several proposals that essentially follow Treasury's initial recommendations to disallow tax benefits for "corporate tax shelters" and to increase the substantial understatement penalty.

Our comments above on Treasury's proposals apply with equal force to H.R. 2255. If anything, the H.R. 2255 proposal disallowing "noneconomic tax attributes" would introduce even greater uncertainty by using terms such as "meaningful changes," "economic position," and "substantial value." This proposal would create tremendous uncertainty for companies following prudent tax planning in implementing business strategies in a global marketplace. Similarly, the H.R. 2255 penalty proposals (like those of Treasury) are overbroad, unnecessary, and punitive.

IV. Conclusion

It is respectfully submitted that Congress should reject the broad legislative proposals regarding "corporate tax shelters" that have been advanced by the Treasury Department, the JCT staff, and others.

The revenue and economic data indicate no need for these radical changes. Further, the proposals are completely unnecessary in light of the array of legislative, regulatory, administrative, and judicial tools available to curtail perceived abuses. Finally, these proposals would create an unacceptably high level of uncertainty and burdens for corporate tax officials while potentially imposing penalties on legitimate transactions undertaken in the ordinary course of business. Proponents of this type of sweeping legislation have not demonstrated that these proposals are necessary or advisable in our corporate tax system.

Appendix 1

Corporate Income Tax Receipts, FY 1980–1999

[Billions of current dollars]

Fiscal year	GDP	Federal corporate income tax receipts	Corporate tax receipts as a percent of GDP
1980	$2,719	$64.6	2.4%
1981	$3,048	$61.1	2.0%
1982	$3,214	$49.2	1.5%
1983	$3,423	$37.0	1.1%
1984	$3,819	$56.9	1.5%
1985	$4,109	$61.3	1.5%
1986	$4,368	$63.1	1.4%
1987	$4,609	$83.9	1.8%
1988	$4,957	$94.5	1.9%
1989	$5,356	$103.3	1.9%
1990	$5,683	$93.5	1.6%
1991	$5,862	$98.1	1.7%
1992	$6,149	$100.3	1.6%
1993	$6,478	$117.5	1.8%
1994	$6,849	$140.4	2.1%
1995	$7,194	$157.0	2.2%
1996	$7,533	$171.8	2.3%
1997	$7,972	$182.3	2.3%
1998	$8,404	$188.7	2.2%
1999	$8,851	$184.7	2.1%
Period averages:			
1980–99	$5,529.9	$105.5	1.9%
1980–82	$2,993.7	$58.3	1.9%
1983–85	$3,783.7	$51.7	1.4%
1986–89	$4,822.5	$86.2	1.8%
1990–92	$5,898.0	$97.3	1.6%
1993–99	$7,611.6	$163.2	2.1%

AASources: Congressional Budget Office, Historical Budget Data, The Economic and Budget Outlook: Fiscal Years 2000–2009, released January 1999.

AACongressional Budget Office, The Economic and Budget Outlook: An Update, July 1999. U.S. Treasury Department, Monthly Treasury Statement, October 1999 and earlier issues.

Appendix 2

Federal Corporate Tax Liability and Receipts, 1980–1999

[Billions of dollars]

Calendar year	Federal corp. tax liability [1]	Federal corp. income tax receipts		
		Gross	Refunds	Net
1980	$58.6	$72.0	$8.6	$63.4
1981	$51.7	$75.1	$13.4	$61.7
1982	$33.9	$63.5	$19.5	$44.0
1983	$47.1	$64.6	$22.7	$41.9
1984	$59.1	$75.5	$16.9	$58.6

Federal Corporate Tax Liability and Receipts, 1980–1999—Continued

[Billions of dollars]

Calendar year	Federal corp. tax liability [1]	Federal corp. income tax receipts		
		Gross	Refunds	Net
1985	$58.5	$78.7	$16.1	$62.6
1986	$66.0	$84.1	$17.8	$66.3
1987	$85.5	$105.2	$18.0	$87.2
1988	$93.6	$114.4	$16.0	$98.5
1989	$95.5	$113.9	$14.1	$99.8
1990	$94.4	$112.9	$15.9	$96.9
1991	$89.0	$112.9	$16.6	$96.4
1992	$101.8	$119.7	$16.6	$103.1
1993	$122.3	$137.3	$13.7	$123.6
1994	$136.2	$158.9	$14.7	$144.2
1995	$155.9	$180.4	$17.9	$162.5
1996	$172.9	$191.8	$19.8	$172.1
1997	$189.5	$211.1	$19.8	$191.3
1998	$183.2	$213.5	$28.5	$185.0
1999 [2]	$198.0			
1999 [3]		$216.4	$31.8	$184.6

[1] Determined from the National Income and Product Accounts as profits before tax (domestic basis) minus profits of the Federal Reserve Banks minus state and local income taxes. See text for details.

[1] Figure is seasonally adjusted at an annual rate based on first six months of the year.

[3] Figures are seasonally adjusted at annual rates based on first nine months of the year.

AASources: U.S. Commerce Dept., Bureau of Economic Association, Survey of Current Business, October, 1999.

AAU.S. Treasury Department, Monthly Treasury Summary, October 1999 and earlier issues. PwC calculations.

Appendix 3

Effective Corporate Tax Rate, NIPA, 1980–1999

[Billions of dollars]

Calendar year	GDP	Corp. profits before tax (BEA adj.[1]	Federal corp. tax liability (BEA adj.)	Federal corp. tax liability (BEA adj.) as a percent of corp. profits before tax	Corp. profits before tax (BEA adj.) as a percent of GDP
1980	$2,784.2	$200.8	$58.6	29.2%	7.2%
1981	$3,115.9	$193.6	$51.7	26.7%	6.2%
1982	$3,242.1	$142.9	$33.9	23.7%	4.4%
1983	$3,514.5	$181.1	$47.1	26.0%	5.2%
1984	$3,902.4	$212.3	$59.1	27.8%	5.4%
1985	$4,180.7	$215.4	$58.5	27.2%	5.2%
1986	$4,422.2	$238.0	$66.0	27.7%	5.4%
1987	$4,692.3	$255.9	$85.5	33.4%	5.5%
1988	$5,049.6	$305.2	$93.6	30.7%	6.0%
1989	$5,438.7	$290.0	$95.5	32.9%	5.3%
1990	$5,743.8	$281.1	$94.4	33.6%	4.9%
1991	$5,916.7	$287.3	$89.0	31.0%	4.9%
1992	$6,244.4	$317.8	$101.8	32.0%	5.1%
1993	$6,558.1	$369.5	$122.3	33.1%	5.6%
1994	$6,947.0	$399.5	$136.2	34.1%	5.8%
1995	$7,269.6	$499.9	$155.9	31.2%	6.9%
1996	$7,661.6	$537.6	$172.9	32.2%	7.0%
1997	$8,110.9	$559.7	$189.5	33.9%	6.9%
1998	$8,511.0	$587.3	$183.2	31.2%	6.9%
1999 [2]	$8,873.4	$603.4	$197.5	32.7%	6.8%
Period averages:					
1980–99	$5,609.0	$333.9	$104.6	31.3%	6.0%
1980–82	$3,047.4	$179.1	$48.1	26.8%	5.9%
1983–85	$3,865.9	$203.0	$54.9	27.1%	5.2%
1986–86	$4,900.7	$272.3	$85.1	31.3%	5.6%
1990–92	$5,968.3	$295.4	$95.1	32.2%	4.9%

Effective Corporate Tax Rate, NIPA, 1980–1999—Continued

[Billions of dollars]

Calendar year	GDP	Corp. profits before tax (BEA adj.[1]	Federal corp. tax liability (BEA adj.)	Federal corp. tax liability (BEA adj.) as a percent of corp. profits before tax	Corp. profits before tax (BEA adj.) as a percent of GDP
1993–99	$7,704.5	$508.1	$165.4	32.5%	6.6%

[1] Figures for 1997–1999 are based on CBO fiscal year projections. Because actual corporate capital gains data were not available for 1980–82, imputations were used.

[2] Figures for 1999 are annualized based on first six months, seasonally adjusted.

AASources: U.S. Commerce Department, Bureau of Economic Analysis, Survey of Current Business, October 1999.

AAU.S. Treasury Department, Monthly Treasury Summary, October 1999. PwC Calculations

Appendix 4

U.S. Corporate Income Tax Liability per Audited Financial Statements, 1988–1998

[Dollar amounts in billions; Tax years ending after May of indicated year, and before July of following year]

Item	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	96Aug	97Aug	98Aug	Avg '88–97
A. Companies with foreign operations														
U.S. fed. inc. tax liability [1]	$25	$24	$25	$23	$23	$27	$34	$41	$42	$48	$19	$22	$24	$31
U.S. oper. inc. after state inc. tax	$127	$144	$138	$123	$128	$149	$181	$222	$231	$234	$89	$103	$105	$168
U.S. assets	$1,408	$1,587	$1,753	$1,904	$1,996	$1,988	$2,310	$2,433	$2,595	$2,494	$905	$1,050	$1,071	$2,047
U.S. revenues	$1,063	$1,212	$1,313	$1,371	$1,423	$1,373	$1,529	$1,745	$1,794	$1,770	$736	$817	$841	$1,459
U.S. fed. inc. tax liability as % of:														
U.S. oper. inc. after state inc. tax	19.9%	16.6%	18.2%	19.1%	18.3%	18.2%	19.0%	18.3%	18.4%	20.7%	21.7%	21.4%	22.6%	18.7%
U.S. assets	1.8%	1.5%	1.4%	1.2%	1.2%	1.4%	1.5%	1.7%	1.6%	1.9%	2.1%	2.1%	2.2%	1.5%
U.S. revenues	2.4%	2.0%	1.9%	1.7%	1.6%	2.0%	2.2%	2.3%	2.4%	2.7%	2.6%	2.7%	2.8%	2.2%
Number of corps.	700	746	806	886	963	820	934	1,057	1,159	1,178	633	633	633	925
B. Companies without foreign operations														
U.S. fed. inc. tax liability [1]	$17	$19	$20	$23	$24	$22	$25	$27	$29	$29	$24	$26	$29	$24
U.S. oper. inc. after state inc. tax	$106	$116	$118	$123	$136	$115	$130	$149	$157	$157	$131	$144	$150	$131
U.S. assets	$1,332	$1,488	$1,570	$1,658	$1,825	$1,627	$2,061	$2,295	$2,526	$2,676	$2,124	$2,493	$2,907	$1,906
U.S. revenues	$913	$1,016	$1,117	$1,182	$1,286	$1,079	$1,252	$1,398	$1,509	$1,564	$1,214	$1,403	$1,593	$1,232
U.S. fed. inc. tax liability as % of:														
U.S. oper. inc. after state inc. tax	15.7%	16.3%	17.3%	18.4%	18.0%	19.2%	19.6%	18.2%	18.7%	18.6%	18.1%	18.0%	19.4%	18.1%
.S. assets	1.2%	1.3%	1.3%	1.4%	1.3%	1.4%	1.2%	1.2%	1.2%	1.1%	1.1%	1.0%	1.0%	1.2%
U.S. revenues	1.8%	1.9%	1.8%	1.9%	1.9%	2.1%	2.0%	1.9%	1.9%	1.9%	2.0%	1.9%	1.8%	1.9%
Number of corps.	3,681	3,573	3,646	3,731	3,945	3,696	3,847	4,209	4,249	4,052	3,357	3,357	3,357	3,863
C. Companies with and without foreign operations														
U.S. fed. inc. tax liability [1]	$42	$43	$45	$46	$48	$49	$60	$68	$72	$78	$43	$48	$53	$55
U.S. oper. inc. after state inc. tax	$233	$261	$256	$246	$264	$264	$310	$372	$387	$391	$220	$247	$256	$298
U.S. assets	$2,740	$3,075	$3,323	$3,562	$3,821	$3,615	$4,371	$4,727	$5,120	$5,171	$3,030	$3,543	$3,978	$3,952
U.S. revenues	$1,976	$2,228	$2,430	$2,553	$2,709	$2,452	$2,781	$3,143	$3,302	$3,332	$1,950	$2,220	$2,434	$2,691
U.S. fed. inc. tax liability as % of:														
U.S. oper. inc. after state inc. tax	18.0%	16.5%	17.8%	18.8%	18.2%	18.7%	19.2%	18.3%	18.5%	19.9%	19.6%	19.4%	20.7%	18.5%
U.S. assets	1.5%	1.4%	1.4%	1.3%	1.3%	1.4%	1.4%	1.4%	1.4%	1.5%	1.4%	1.4%	1.3%	1.4%
U.S. revenues	2.1%	1.9%	1.9%	1.8%	1.8%	2.0%	2.1%	2.2%	2.2%	2.3%	2.2%	2.2%	2.2%	2.0%
Number of corps.	4,381	4,319	4,452	4,617	4,908	4,516	4,781	5,266	5,408	5,230	3,990	3,990	3,990	4,788

AACurrent provision for tax.

AASource: Standard and Poors, Compustat, September 1999; PwC calculations.

APPENDIX 5

Net Capital Gains for All Active Corporations, 1980–1996

[Excluding RICs in Billions of dollars]

Year	Net gain on capital assets		
	Net short-term gain less net long-term loss	Net long-term gain less net short-term loss	Subtotal
1980	1.4	22.1	23.5
1981	1.7	25.6	27.3
1982	1.9	24.1	26.0
1983	2.7	28.4	31.1
1984	2.4	35.1	37.6
1985	4.3	45.9	50.2
1986	8.2	74.2	82.4
1987	4.4	54.5	58.9
1988	4.0	56.7	60.7
1989	6.0	62.5	68.5
1990	2.9	43.4	46.3
1991	7.1	41.1	48.2
1992	7.9	45.1	53.0
1993	10.8	53.3	64.1
1994	2.4	47.9	50.3
1995	10.0	60.9	70.8
1996	6.6	75.2	81.8

Source: IRS. Corporate Source Book, various issues.

APPENDIX 6

Arrangements with a ''Significant Purpose'' of Avoidance or Evasion of Tax and Resulting in an Understatement for Corporate Taxpayers

Highest standard met	Described by an indicator	Disclosure requirements satisfied	Penalty under present law	Penalty under staff recommendation
Highly Confident	Yes	Yes	0	0
Highly Confident	Yes	No	0	40%
Highly Confident	No	Deemed*	0	0
More Likely Than Not	Yes	Yes	0	20
More Likely Than Not	Yes	No	0	40
More Likely Than Not	No	Deemed*	0	20
Substantial Authority	Yes	Yes	20	20
Substantial Authority	Yes	No	20	40
Substantial Authority	No	Yes**	20	20
Substantial Authority	No	No**	20	40
Less Than Substantial Authority: All Cases			20%	40%

AA* Under the Joint Committee staff recommendations, a transaction that is Not described by an indicator is Not a ''reportable transaction.'' Therefore, to the extent that a ''more likely than Not'' or higher standard has been satisfied, there is No special tax shelter disclosure or general section 6662(d)(2)(B) return disclosure required in order to reduce penalties.

AA** These transactions would Not be ''reportable transactions'' to which the special corporate tax shelter disclosures apply. Under the Joint Committee staff recommendations, however, transactions that are Not described by a tax shelter indicator nevertheless must satisfy the new, higher section 6662 reporting standards that are recommended in Part VII.G., above. Therefore, if the highest standard satisfied by a transaction is substantial authority, general tax return disclosure rules (***i.e.,*** sec. 6662(d)(2)(B) and Treas. Reg. sec. 1.6662–3(c)(2)) must be satisfied in order to abate the penalty, even if the special corporate tax shelter disclosure requirements do Not apply. Thus, the disclosure indicated in the boxes accompanying this footnote actually refers to the section 6662(d)(2)(B) disclosure and Not corporate tax shelter disclosure.

AAKey

AAHighly Confident:—75 percent or greater likelihood of success on the merits if challenged.

AAMore Likely than Not:—Greater than 50 percent likelihood (but less than highly confident) of success on the merits if challenged.

AASubstantial Authority:—Less than more likely than Not, but greater than reasonable basis.

Chairman ARCHER. Mr. Hariton, you may proceed.

STATEMENT OF DAVID P. HARITON, PARTNER, SULLIVAN & CROMWELL, NEW YORK, NEW YORK

Mr. HARITON. Thank you very much. I don't have Mr. Kies' experience, so I may not time it so perfectly. My name is David Hariton. I am a tax lawyer practicing in New York, and my practice deals with the taxation of complex business transactions. I have done a lot of thinking about these issues. I have written about these issues, and I am speaking here strictly on my own behalf and for the benefit of the Government and the Treasury Department.

And I say what I am about to say now with the greatest appreciation and gratitude for everyone who has spent time trying to deal with this problem, especially Representative Doggett and his staff. I have concluded that the most constructive response that Congress could make would be to grant the Commissioner additional financial resources to deal with complex business transactions.

And if we are going to have a statutory response, it really can't be one that is based on some definition of abusive tax transactions. That is just hopeless. At most, it might be one that is designed to shift the balance, like an increase in the penalty for understatements arising from corporate tax shelters.

Now, I have already set out in various articles the issues that I think would have to be addressed before we could develop any sort of coherent language to define corporate tax shelter, and I would be glad to assist the government in the effort if I was called upon.

I must tell you frankly, though, that I really think there is little to be gained from such language. The law in this area is very complex, and the transactions to which the law applies are even more complex. And when you are talking about the application of the former to the latter, that is as unique and case-specific as any particular chess game. That is why we have hundreds of pages of a court decision trying to explain a particular transaction.

And any string of words that purports to define bad transactions and distinguish them from good ones is going to be ignored as functionally meaningless and impossible to apply or even comprehend. At most, I think it would cast a shadow of confusion over the objective rules that determine tax liabilities.

Besides, to be honest, I am not persuaded that such a definition is necessary. I think that the courts have made it quite clear that they will not permit sophisticated taxpayers to reap the unjust benefits of strictly tax-motivated transactions. The Commissioner has enough judicial doctrines at his disposal to successfully challenge any taxpayer that seeks to take unfair advantage of his rules. The problem really is not that the Commissioner has litigated and lost.

In other words, I don't think this is a job for law. This is a job for administration. And an increase in the volume of law instead of in the volume and quality of enforcement is not going to accomplish very much.

It is administration, not law, that can apply analytical reasoning to specific transactions. Administration, not law, can distinguish legitimate transactions from abusive ones. Laws don't think, people do; and I think we would be foolish to suppose that we could draft a definition to do our thinking for us.

Now, having said that, I must say that I have a great deal of sympathy for the Commissioner's complaint that he is outmanned and ill-equipped to deal with this problem. In order to deal adequately with complex tax motivated transactions, the Commissioner has got to be proactive, energetic and efficient; yet at the same time, he has got to be fair, judicious, reflective, cerebral. How is he supposed to hire a staff to accomplish all of these tasks with a limited budget and a government salary cap?

Is it a surprise to learn that he may be losing tens, even hundreds of billions of dollars? I have to say, for me at least, I think that the way that we are dealing with our own Treasury Department may be pennywise and pound foolish.

Now, I do realize that some people are concerned about the problems that the little guy faces in dealing with the IRS. But obviously we are not talking about the little guy here. These are transactions entered into by large corporations and wealthy individuals. Isn't it possible for Congress to grant the Commissioner special financial resources and tell them not to use them to prosecute the little guy, but rather to deal energetically with complex tax motivated transactions?

And I think you should also find some way to let the Commissioner pay his staff more. The Commissioner is not going to be able to handle complex business transactions if he can't compete with the private sector in hiring the best and the brightest. Does it make sense to bind someone who is trying to collect our revenue to the salary caps that are designed to save the government money?

Anyway, thank you very much for your time. And I will say that I am very glad that you are focusing on the taxation of complex business transactions. I just hope that your concern will yield up measures that are practical and efficacious, as opposed to just ceremonial.

Chairman ARCHER. Thank you, Mr. Hariton, and you did very well by the time.

[The prepared statement follows:]

Statement of David P. Hariton, Partner, Sullivan & Cromwell, New York, New York

As a tax lawyer whose practice deals with complex business transactions, I hope to offer a practical view on the problem which the Committee is now addressing. I have concluded on reflection that the most constructive response that Congress could make would be to grant the Commissioner additional financial resources to deal with complex business transactions. If there is to be a statutory response, it should not be one that places significant weight on a statutory definition of abusive tax transactions. At most, it should be one designed to shift a perceived imbalance, such as an increase in the penalty for understatements arising from corporate tax shelters.

I have already endeavored to assist the government by setting out in published articles the issues that must be considered in drafting statutory language to better define the words "corporate tax shelter," and I would be glad to continue that assistance if called upon. I must tell you frankly, however, that there is little to be gained by enacting legislation that purports to describe bad transactions and distinguish them from good ones. The law in this area is exceedingly complex, the transactions to which the law applies are even more so, and application of the former to the latter is as unique and case-specific as any particular chess game. Laws which purport to define bad transactions are likely to be ignored as functionally meaningless—impossible to apply or even comprehend. At most, they will do damage by casting a shadow of confusion over the primarily objective rules that determine tax liabilities.

Moreover, I am not persuaded that such laws are necessary. A series of recent decisions clearly demonstrates that the courts will not permit sophisticated taxpayers to reap the unjust benefits of strictly tax-motivated transactions. The case law has sufficient judicial doctrines to permit the Commissioner to successfully challenge taxpayers that seek to take unfair advantage of his rules. The problem is not that the Commissioner has litigated and lost.

In other words, this is not a job for law. This is a job for administration. I fear that a decision to increase the volume of law instead of the volume and quality of enforcement will accomplish nothing constructive. It is administration, not law, which can apply analytic reasoning to specific transactions and perform the all-important task of distinguishing legitimate transactions from abusive ones. Laws don't think—people do—and we would be foolish to suppose that we could somehow draft laws to do our thinking for us.

I am highly sympathetic, however, to the Commissioner's complaint that he is outmanned and ill-equipped to deal with the substantial increase in intellectual resources that the private sector is now directing towards complex tax-motivated transactions. To deal with the problem, his staff must be proactive, energetic and efficient, yet at the same time judicious, fair, reflective and cerebral. How can the Commissioner muster a staff to accomplish these tasks with his hands tied behind his back? Is it any surprise that he is losing tens, perhaps hundreds, of billions of dollars? The way we are dealing with our own Treasury is, to be frank, penny-wise and pound-foolish.

I understand that some people are concerned about the problems that the little guy faces in dealing with the IRS. The transactions we are discussing, however, are entered into by large corporations and massively wealthy individuals. Surely it is possible for Congress to grant the Commissioner special resources and direct that he use them not to prosecute the little guy, but rather to deal energetically with complex tax-motivated transactions.

I must stress, moreover, that it will not be enough for the Commissioner to hire more people. When it comes to complex business transactions, the Commissioner must compete with the private sector to hire the best and the brightest. Frankly, how can he do this if he is bound by the salary caps which generally apply to all government workers? Does it come as any surprise to learn that the Commissioner's staff has difficulty keeping up with people who earn ten times as much in the private sector, or that when the Commissioner directs them to increase enforcement, they wind up targeting legitimate business transactions while the transactions they are really trying to stop elude their grasp? We cannot remedy the problem if we insist upon being deaf and blind to mundane realities.

Thank you for your time. As a tax lawyer and an individual who recognizes how much revenue is at stake, I hope you grow more, not less, concerned with the taxation of complex business transactions. I merely hope that your concern will manifest itself in measures that are practical and efficacious, as opposed to merely ceremonial.

Chairman ARCHER. Dr. Sullivan.

STATEMENT OF MARTIN A. SULLIVAN, PH.D., ECONOMIST, TAX ANALYSTS, ARLINGTON, VIRGINIA

Mr. SULLIVAN. Good afternoon, Mr. Chairman, Mr. McCrery, Mr. Doggett. It is an honor for me to appear here today. My name is Martin Sullivan, I am an economist. Anticipating a question from you, everybody in our profession is upright and there are no ethical conflicts, on the one hand.

I work for Tax Analysts, which is a nonprofit, nonpartisian organization in Arlington, Virginia. It is best known as the publisher of Tax Notes Magazine, which I know you all read faithfully every week, and I appreciate that.

I am honored to be here today. I really am trying to help. So let me just go to what I know. Let me just tell you what I don't know. I don't know anything about corporate tax shelters. It is way too complex for me. In fact, I was trying not to learn about them at

all and avoid them, because they are too hard for a simple-minded economist such as myself. But the data at the other end of the telescope, if you will, just made it obvious I couldn't avoid it anymore or at least think about it a little bit.

For the fiscal year 1999 that ended on September 30th, the Treasury Department collected $184 billion in receipts from the corporation income tax. This is down 2.5 percent from the prior year. I don't have charts, I just have little pieces of paper. If you would like to follow along with me, they are labeled chart 1, chart 2 and chart 3 in the testimony.

The question is, we see that corporate testimony receipts have gone down this year. Is that a big deal? Is that something we should be concerned about? Well, I don't know definitely, but let us just go through what the possibilities might be. Let us look at the history. We have never had a decline in corporate tax receipts before— we have only had it two times in the last 20 years; the first time was in the early 1980s when we had a really big recession and a really big tax cut, so that makes senses. The only other time was in 1990, when we had a smaller recession so that kind of makes sense.

But right now we are not in the recession, as we all know and are thankful for, and we haven't had any big tax cuts. So in fact, profits are up; if anything, we have had legislation where corporate receipts are supposed to increase. Even the Chairman's press release indicates $50 billion of extra receipts from corporations should be expected over the last few years. We have had a rate increase from 34 to 35 percent, ill-advised in my opinion, but nevertheless there as a result of the 1993 act.

So it is not legislation. It is not a recession. Why are corporate tax receipts going down? Well, the next thing to look at is profits, d that is what I did. If you look on chart 3, I sort of constructed an effective tax rate. And again if you just look at the history, it sort of makes sense. 1981, 1982, 1983, 1984, we had a big recession and we had a big tax cut. Corporate profits go down. In 1987, receipts go up as a result of the Tax Reform Act of 1987.

In 1991, 1992, receipts are low, because of the recession. But again you have this declining pattern starting around 1994. What is it due to? I am not sure. The possibilities are—we mentioned legislation. I think it is clearly true that it is not legislation.

The second thing might be an increased investment in plant and equipment. Because of the way that the depreciation allowances work, tax depreciations are faster than book depreciation. That could be a reason. I just saw in the Treasury testimony that indicates that it might not be the reason. I think that deserves further study.

The other possible reason might be an increase you have in noncorporate entities like S corporations. I don't think that is big enough to explain the entire shortfall but it might be there.

Another reason might be an increased use in exercised stock options by executives of corporations because they deduct it for tax purposes but not for book purposes, and the other reason might be some sort of statistical fluke that is in the data. These are very complex data. But the other—the reason why I am here today is

that the other possible reason, it might be corporate tax shelters. It might not be.

The point is I think there clearly is a downward trend here. The trend could be as large as 10 or $20 billion a year annually.

But I think, just to conclude, that it would be foolish to take this data as gospel. On the other hand, it would be foolish to ignore this data at this time.

Thank you very much. I would be glad to answer any questions.

Chairman ARCHER. Thank you, Dr. Sullivan.

[The prepared statement follows:]

Statement of Martin A. Sullivan, Ph.D., Economist, Tax Analysts [1]

1. THE RECENT DECLINE IN CORPORATE INCOME TAX RECEIPTS

For the fiscal year 1999 that ended on September 30th, the Treasury Department collected $184 billion in receipts from the corporation income tax. This is down 2.5 percent from the prior year.

Prior to 1999, there have been two periods over the last two decades when corporate income tax receipts declined. First, there was a huge drop in corporate tax receipts in the early 1980s. This was due to the combination of two factors: (1) the massive amount of corporate tax relief provided by the Economic Recovery Tax Act of 1981 and (2) the 1981–82 recession, the deepest business cycle downturn since the 1930s.

The second period of decline was in 1990 when corporation income tax receipts declined by 9.9 percent. This decline coincided with a small recession that began in July of 1990 and ended in March of 1991.

Chart 1 shows the annual rate of growth in corporation income tax receipts from 1979 though 1999.

What is striking about the 1999 decline in corporate tax receipts is that it does not come in the midst of a recession or after legislation including any significant corporate tax relief. The U.S. economy is booming. And, if anything, on net over the last five years Congress has legislated more income tax increases than decreases for U.S. corporations.

Chart 2 compares the growth rate of real GDP with the growth in corporate receipts. Except for the late 1990s, percentage changes in corporation income tax receipts have generally moved with changes in overall economic growth (as measured by changes in real GDP) over the last two decades. Since 1995, the growth rate in corporation income tax receipts has declined despite strong economic growth.

2. DO DECLINING CORPORATE PROFITS EXPLAIN DECLINING CORPORATE RECEIPTS?

If a recession or legislation cannot explain the recent decline in corporate tax receipts, the next most likely explanation would be a decline in the amount of profits.

There is no perfect measure of true economic profits. The most widely-cited profit figure is that estimated by national income accountants of the Bureau of Economic Analysis of the Commerce Department. This data (adjusted slightly to align calendar year data with fiscal year data and to provide consistency over time) does show that there recently has been a decline in the rate of growth corporate profits in the late 1990s. But the decline in corporate receipts has been significantly larger than the decline in profits as measured by the Commerce Department.

[1] Tax Analysts is a non-partisan, non-profit organization located in Arlington, Virginia. It can be accessed on the world wide web at www.tax.org. This testimony reflects the views of the author and should not in any way be attributed to Tax Analysts. Much of the information contained in this testimony is from "Shelter Fallout? Corporate Taxes Down, Profits Up," Tax Notes, August 2, 1999 and "Despite September Surge, Corporate Tax Receipts Fall Short," Tax Notes, October 25, 1999.

Chart 1. Annual Percentage Change in U.S. Corporation Income Tax Receipts, 1979-1999

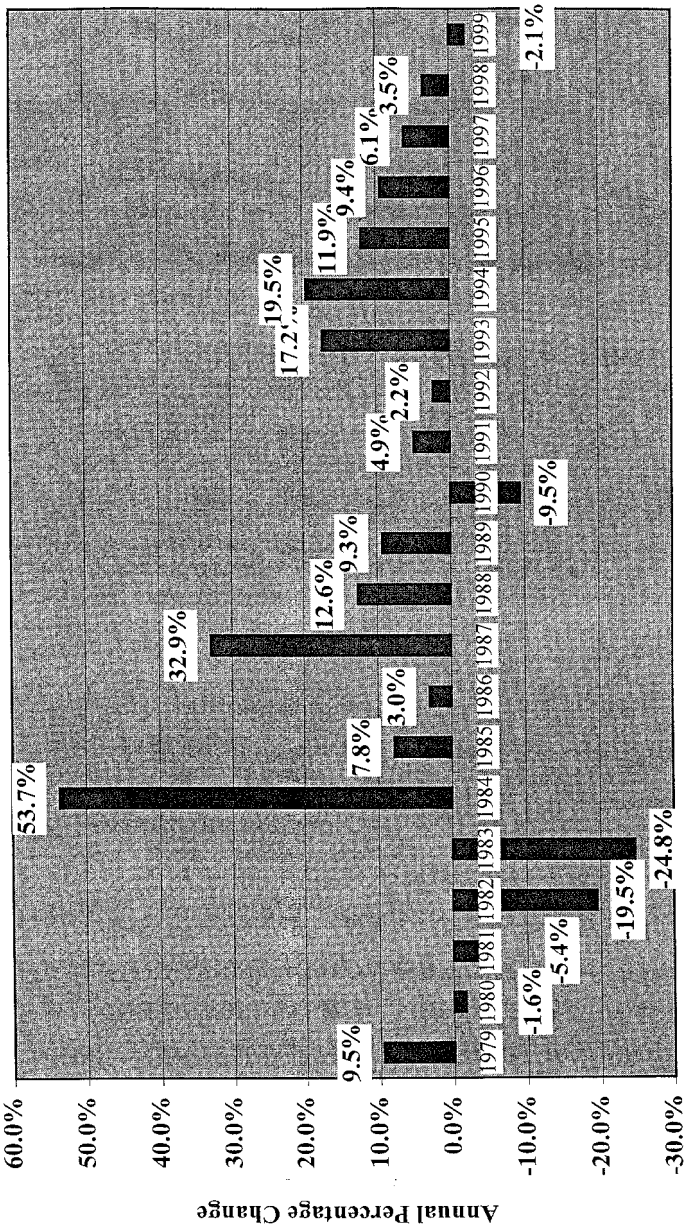
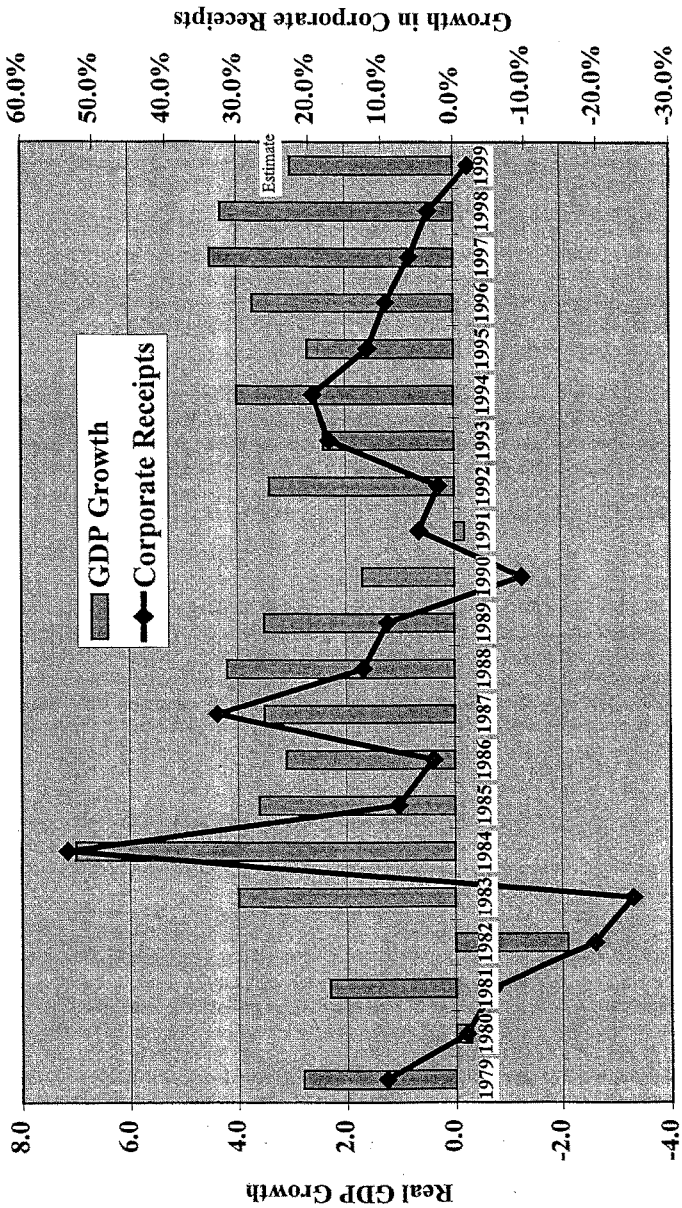


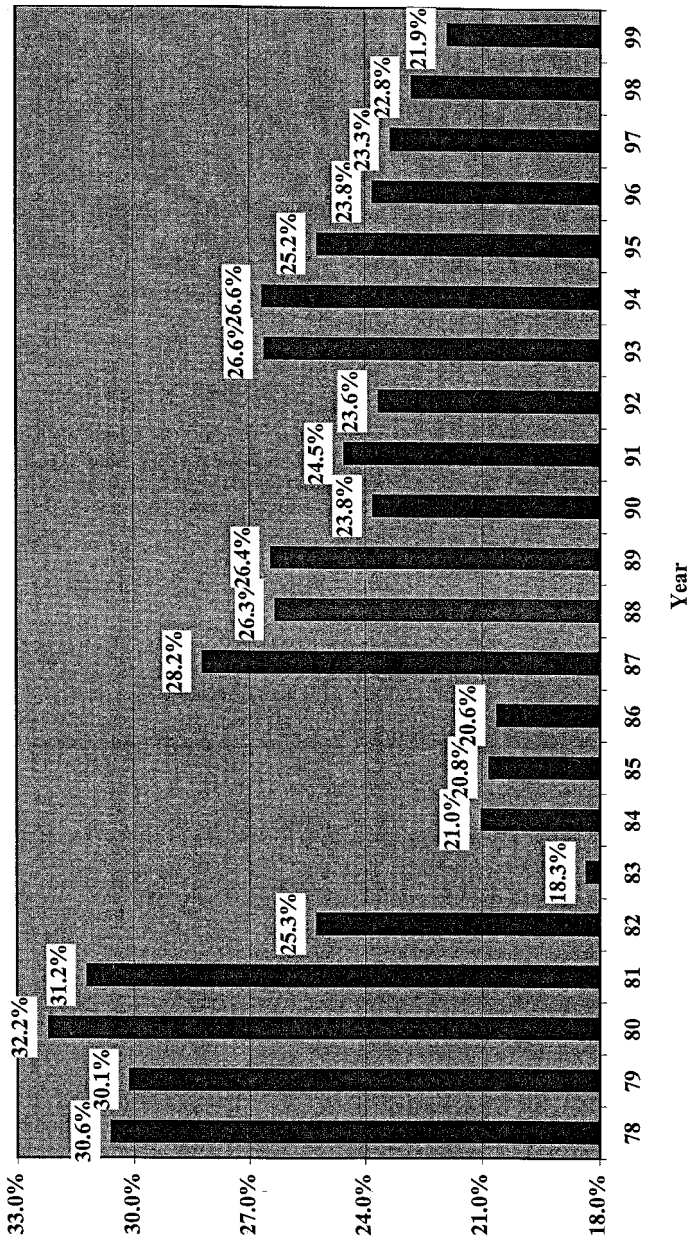
Chart 2. Annual Percentage Change in Real GDP and Corporation Income Tax Receipts



One way to explore whether declining receipts are attributable to lower profits is to construct a ratio of corporate receipts to profits and observe the movement of this ratio over time. (Sometimes the ratio of corporation income tax receipts to profits is thought of as an "effective tax rate.")

Chart 3 shows the ratio of corporation income tax receipts to corporate profits as measured by the Commerce Department from 1978 through 1999. (Please see the appendix at the end of this testimony for explanation and sources of the estimates.)

Chart 3. Ratio of Corporation Income Tax Receipts to Corporate Book Profits, 1978-1999



Corporation tax receipts were in excess of 30 percent of book profits in the late 1970s. As a result of corporate tax cuts included in the Economic Recovery and Tax Act of 1981, corporate income tax receipts declined dramatically to 18.3 percent of profits in 1983—the lowest ratio in the two decades from 1978 to 1999. Following the 1982 Tax and Fiscal Responsibility Act taking effect in 1983, corporate tax receipts as a percentage of profits rose to the low twenties through 1985. The 1986 Tax Reform Act got the ratio up to the middle twenties. The ratio peaked at 26.6 percent in both 1993 and 1994.

Despite the increase in the top corporation income tax rate from 34 to 35 percent after passage of the 1993 Act, the ratio has steadily declined until it reached its twelve-year low in 1999. The ratio of corporation income tax receipts to corporation book profits now stands at 21.8 percent. The average ratio for the prior three years prior to 1999 was 23.3 percent. The average ratio for the five years prior to 1999 was 24.3 percent. The average ratio for the ten years prior to 1999 was 24.7 percent. So, depending on one's perspective, the tax-to-profit ratio is "too low" by 1.4 percent, 2.4 percent, or 2.8 percent. (See Table B of Appendix for details.)

How significant are these reductions in the ratio? According to the Commerce Department, corporate profits are now about $850 billion annually. Therefore, each percentage point decline in the ratio of corporate tax represents a loss of about $8.5 billion to the Treasury. Depending on what one considers to be a "normal" ratio of taxes to profits, the "shortfall" in corporation income tax receipts in 1999 is in a neighborhood between $12 and $24 billion.

Using an average of prior-year ratios is only one standard for comparing current levels of corporate taxation. It is arbitrary. Nobody can say with authority what level corporate profits should be. But whatever measure is used, it is clear that there is a decline in corporate profitability in the last few years that probably amounts to more than $10 billion annually.

3. Possible Reasons for Declining Effective Tax Rates

Observing is one thing. Explaining is another. What has caused this decline in the taxation in corporate profits over the last five years? Here is a list of possible explanations.

(1) *Legislation*. Congress has passed a lot of tax laws in the last ten years. But there has been relatively little in the way of corporate income tax reductions. In 1997, there was a significant reduction in the corporate alternative minimum tax, but the estimated revenue impact of this change was only about $1.5 billion for 1999. Offsetting this has been a fair number of small provisions raising corporate taxes. (Extensions of expiring provisions are significant but because they are merely extensions they would not explain declines in corporate revenue.) Perhaps the largest recent corporate tax change was the increase in the top corporate tax rate from 34 to 35 percent enacted as part of the Omnibus Budget Reconciliation Act of 1993. This provision increased corporate tax revenue by approximately $5 billion annually. In conclusion, if anything, the likely impact of recent tax legislation has been to increase the ratio of corporate taxes to corporate profits.

(2) *Increased investment in plant and equipment*. As a result of the 1986 Act, tax depreciation is not nearly as accelerated as it had been before 1986. Still, depreciation allowances are generally more accelerated for tax purposes than for book purposes. Therefore, a rapid increase in investment could cause tax depreciation to rise relative to book depreciation and therefore tax profits to decline relative to book profits. During the five year period from 1994 though 1999, nonresidential fixed investment in the United States increased at an average annual inflation-adjusted rate of 9.9 percent. During the prior five-year period (from 1989 through 1993) the corresponding figure was only 1.5 percent. Without the availability of a depreciation simulation model, like those that are used by the Treasury Department and Joint Tax Committee economists, it is difficult to gauge whether increased investment can explain the recent decline in corporate income taxes.

(3) *Increased use of noncorporate entities*. Changes in federal and state laws have made use of Subchapter S corporations, limited partnerships, and limited liability companies increasingly popular by small and mid-size businesses. Because these alternative forms are generally not an option for the largest U.S. corporations (from whom the vast bulk of corporation income tax is collected), there is no reason to expect this type of self-help to soon wipe out the corporation income tax. But increased use of pass-through entities might explain some significant portion of the declines in corporation tax in recent years.

(4) *Increase in exercised stock options*. An increasingly popular method of compensating executives is the use of stock options. There are tax and accounting advantages of using stock options as compensation. Since 1993, executive salaries in excess of $1 million are no longer deductible. But stock options can be deductible if they are linked to a firm's financial performance. On the accounting side, stock options are not considered a cost under traditional accounting rules. Stock options are recognized as income (by the executive) and deductible (by the firm) when the stock options are exercised. Therefore, any increase in executives' exercising stock options could reduce corporation income tax receipts without any corresponding decline in book profits.

(5) *Possible statistical fluke.* Perhaps some statistical bias—one way or the other—has seeped into the receipts data tabulated by the Treasury or into the profit data tabulated by the Commerce Department. (The calculation of profits is a complex undertaking explained in a lengthy 1985 Commerce Department Report called "Corporate Profits: Profits Before Tax, Profits Tax Liability, and Dividends" available at *www.bea.doc.gov/bea/ARTICLES/NATIONAL/NIPA/Methpap/methpap2.pdf.* Given the large amount of structural change recently in the U.S. economy, and given the difficulty that statisticians have in tracking these changes, this possibility deserves serious consideration as possible explanation of the apparent decline in the tax-to-profit ratio.

(6) *Other factors.* The drop in corporate tax receipts may be due to some other factors not identified here.

4. Declining Tax Receipts and Corporate Tax Shelters

Among the other possible explanations of the recent decline corporate receipts is the increased use of a variety of aggressive tax planning techniques commonly referred to as "corporate tax shelters." The charts presented in this testimony show a slowdown in the rate of growth of corporate receipts in the mid–1990s. This roughly coincides with the anecdotal evidence about the timing of the increased use of shelters.

In addition, many knowledgeable commentators suspect that tax shelter may be eating into the corporate tax base:

- In its recently released interest and penalty study (JCS–3–99, July 22, 1999), the Joint Committee on Taxation made the following comment on the amount of corporate tax shelter activity: "Although economic information concerning the cost of tax shelters is largely anecdotal, some believe that the resulting revenue loss may be in excess of $10 billion a year."
- In testimony before the Senate Finance Committee, the New York State Bar Association Tax Section stated: "We believe that there are serious, and growing, problems with aggressive, sophisticated and, we believe in some cases, artificial transactions designed principally to achieve a particular tax advantage. . . . There is obviously an effect on revenue. While we are unable to estimate the amount of this revenue loss, anecdotal evidence and personal experience lead us to believe that it is likely to be quite significant." ("Statement of Harold R. Handler on Behalf of the Tax Section, New York State Bar Association, before the Senate Finance Committee," April 27,1999.)
- In its recent white paper on corporate tax shelters (July 1, 1999), the Treasury Department wondered aloud about the relationship between declines in this ratio and tax shelters: "While corporate tax payments have been rising, taxes have not grown as fast as have corporate profits. One hallmark of corporate tax shelters is a reduction in taxable income with no concomitant reduction in book income. The ratio of book income to taxable income has risen fairly sharply in the last few years. Some of this decline may be due to tax shelter activity."

But it is important to remember that a decline in the ratio of tax receipts to profits provides no proof about a relationship between corporate tax shelters and aggregate corporate tax receipts. Such data are only suggestive. The bigger the shortfall, the more suggestive they are.

The situation in many ways is analogous to the use of low profitability of foreign controlled U.S. corporations as evidence of transfer pricing abuses by foreign-headquartered companies operating in the United States. As in the case of the controversy about inbound transfer pricing, finding alternative explanations of low taxes—such as high rates of investment—lessens suspicion that corporate shelter activity causes of lower corporate taxes. On the other hand, if this pattern persists and no alternative explanations are borne out, the likelihood that tax shelters are the cause of declining corporate tax receipts will increase.

By its nature, the aggregate data can never provide conclusive evidence about the relationship between corporation income tax receipts and corporate tax shelters. In the end, Congress and the Administration must base any decisions it makes about tax shelters on uncertain information. Any decision based on solely on information presented here would be foolish. However, any decision ignoring this information similarly would be ill-advised.

Appendix: Explanation of the Data

Historical data on corporate tax receipts are from the Office and Management and Budget, "Budget of the United States Government, Fiscal Year 1999, Historical Tables," Table 2.1, "Receipts by Source: 1934–2003" available at *www.access.gpo.gov/su—docs/budget99/pdf/hist.pdf.* The most recent data on corporate tax receipts are

from the U.S. Department of the Treasury, Financial Management Service, "Monthly Treasury Statement," October 1999, available at *www.fms.treas.gov/mts/mts0999.txt*. These data are shown in Column (2) of Table A below.

Annual corporate profit data used for calculations in this report are from the Commerce Department's Bureau of Economic Analysis (BEA) Quarterly historical data are from the BEA's web site at www.bea.doc.gov/bea/dn/0898nip3/table4.htm. The most recent data are available at www.bea.doc.gov/bea/dn/profits.htm. Data on real GDP growth are also from these same sources.

Ideally, in order to match BEA quarterly data with fiscal-year data from the Treasury, profit data from four consecutive quarters ending with the third quarter of any year would be averaged to arrive at an annual figure for that year. For example, the average of BEA profit data from the last quarter of 1997 and the first three quarters of 1998 is paired with receipts data for fiscal year 1998. The entire series is shown in Column (3) of Table A below.

However, the latest profit data available from BEA are for second quarter of 1999. In order to derive an estimate for 1999 that is consistent with estimates for prior years, average profit data from four consecutive quarters ending with the *second* quarter was used an approximation of average profit data from four consecutive quarters ending with the *third* quarter. For example, the average of BEA profit data from the last two quarters of 1997 and the first two quarters of 1998 are paired with the corresponding receipts data for fiscal year 1998. The entire series is shown in Column (4) of Table A below.

The ratios cited throughout this testimony and in the chart use this profit data and are shown in Column (6). In the interests of full disclosure, corresponding ratios for the more ideal measure are shown in column (5). Using ratios in column (5) do not appreciable change the results.

Table B shows the calculations used to estimate the shortfall in corporate profits in 1999. All data in Table B are from, or are computed from, data shown in Table A.

Table A.—Corporate Profit Data from the Commerce Department, Corporate Income Receipts Data from the Treasury Department, and the Ratio of Receipts to Profits, 1978–1999

Year	Corporation Income Tax Receipts	Corporate Profits (Year Ending in 3rd Qtr.)	Corporate Profits (Year Ending in 2nd Qtr.)	Ratio of Corporate Receipts to Profits (End 3rd Qtr.) [(2)/(3)]	Ratio of Corporate Receipts to Profits (End 2nd Qtr.[(2)/(4)]	Rate of Growth Real Gross Domestic Product
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1978	$60.0	$200.2	$195.9	29.9%	30.6%	5.4%
1979	$65.7	$217.6	$218.1	30.2%	30.1%	2.8%
1980	$64.6	$191.8	$200.6	33.7%	32.2%	−0.3%
1981	$61.1	$206.5	$195.9	29.6%	31.2%	2.3%
1982	$49.2	$186.4	$194.8	26.4%	25.3%	−2.1%
1983	$37.0	$218.4	$201.8	17.0%	18.3%	4.0%
1984	$56.9	$280.1	$270.8	20.3%	21.0%	7.0%
1985	$61.3	$302.0	$294.8	20.3%	20.8%	3.6%
1986	$63.1	$296.0	$306.4	21.3%	20.6%	3.1%
1987	$83.9	$316.4	$297.6	26.5%	28.2%	3.5%
1988	$94.5	$368.5	$359.2	25.7%	26.3%	4.2%
1989	$103.3	$389.5	$390.9	26.5%	26.4%	3.5%
1990	$93.5	$392.0	$393.3	23.9%	23.8%	1.7%
1991	$98.1	$407.0	$400.0	24.1%	24.5%	–0.2%
1992	$100.3	$416.5	$424.3	24.1%	23.6%	3.4%
1993	$117.5	$471.2	$442.0	24.9%	26.6%	2.4%
1994	$140.4	$551.3	$527.0	25.5%	26.6%	4.0%
1995	$157.1	$649.9	$622.8	24.2%	25.2%	2.7%
1996	$171.8	$736.9	$722.7	23.3%	23.8%	3.7%
1997	$182.3	$803.2	$781.8	22.7%	23.3%	4.5%
1998	$188.7	$824.4	$827.9	22.9%	22.8%	4.3%
1999	$184.7	N/A	$844.2	N/A	21.9%	3.0%

Table B.—Calculations Used to Estimate the 1999 ''Shortfall'' in Corporate Tax Receipts under Various Assumptions about ''Normal'' Receipts

	3-Year Avg.	5-Year Avg.	10-Year Avg.
(1) Average of Prior Years	23.3%	24.3%	24.7%
(2) 1999 Ratio	21.9%	21.9%	21.9%
(3) Difference	1.4%	2.4%	2.8%
(4) 1999 BEA Corporate Profits	$844.2	$844.2	$844.2
(5) Estimate of ''Shortfall'' [(3) times (4)]	$11.8	$20.3	$23.6

Chairman ARCHER. Mr. Carpenter, you may proceed.

STATEMENT OF DANNY R. CARPENTER, VICE PRESIDENT-FINANCE, KANSAS CITY SOUTHERN INDUSTRIES, INC., KANSAS CITY, MO

Mr. CARPENTER. Thank you. Good afternoon, Mr. Chairman, and members of the Committee. My name is Danny R. Carpenter and I am Vice President of Finance of Kansas City Southern Industries located in Kansas City, Missouri. It is a pleasure to appear today, and I appreciate the opportunity to be here.

I have been a tax professional for approximately 20 years. At this time I have overall responsibility for tax functions at Kansas City Southern, but not day-to-day responsibility.

Over the past several years, I have been approached at least four to five times to consider transactions designed solely to avoid corporate taxes. I have examined only one of those transactions in depth, and the others only briefly. These transactions had three common elements, as I saw it. First, they were very complex and relied on technical application of tax rules to facts that were contrived to produce benefits never intended by Congress. Second, the transactions involve very sizable fees for professional advisors, investment bankers and others. And third, the transactions had little or no business purpose or economic substance.

My company, KCSI, did not participate in any of these transactions because of the lack of business and economic reality, and also because of concern that a transaction designed exclusively to generate tax benefits would not and should not succeed.

I am not suggesting that my company does not wish to save taxes where possible. We strive to pay no more taxes than the law requires. But we do not believe it is appropriate to engage in a significant transaction unrelated to a company's business, solely or principally to create tax benefits. Such transactions are inconsistent with a self-assessing tax system and should be viewed as abusive and eliminated.

My concern about these transactions also extends to the way they have been developed and promoted. They are not presented, in my experience, as business transactions with nontax economic advantages; rather, they are promoted as transactions to provide tax benefits and for which an attempt would be made to establish a business purpose.

In several instances the names of prominent local or national companies that had undertaken similar transactions were men-

tioned. Presumably that was to add credibility, but it also had the effect of creating competitive pressure, especially for companies in similar businesses. Tax professionals and accounting and law firms apparently have participated in designing these transactions and certainly in promoting and executing them. Without dwelling on these points, I would just say that especially in a self-assessing tax system, we would like to think that tax professionals would help police these kinds of transactions, not design and promote them.

Finally, I would like to express my concern about possible solutions. Because of difficulties in finding a remedy for each individual transaction, there may be a tendency towards broad solutions for all such transactions. But broad standards mean that implementing regulations take years to complete and possible years of litigation will be required to develop meaningful rules. Broad solutions also establish traps for the unwary, produce unanticipated consequences, and create enormous costs and burdens for our tax administration system. Accordingly, broad, general solutions and vague standards must be avoided.

While I do not believe the transactions I have seen would survive an IRS challenge under existing law, I recognize that under our current system, the IRS could easily be overwhelmed if there is widespread adoption of abusive techniques, as seems to be occurring. Accordingly, I believe congressional action is needed, at least to aid in the detection of these transactions through additional disclosure requirements, and probably also to strengthen existing anti-abuse rules.

Thank you very much for the opportunity to appear and offer comments on a very important issue.

[The prepared statement follows:]

Statement of Danny R. Carpenter, Vice President-Finance, Kansas City Southern Industries, Inc., Kansas City, Missouri

Good afternoon Mr. Chairman, Mr. Rangel, and members of the Committee. It is my pleasure to appear today in conjunction with the Committee's examination of so-called corporate tax shelters. I am Vice President-Finance for Kansas City Southern Industries, Inc. ("KCSI").

I have been a tax professional for approximately 20 years, first as an attorney in private practice, and since 1993, with Kansas City Southern Industries, Inc. Until May 1995, I served as Vice President-Tax and Tax Counsel for KCSI, and I continue to have overall (not day-to-day) responsibility for tax functions at KCSI.

Over the past several years, I have been approached on four or five occasions to consider transactions that were designed simply to avoid corporate taxes. On one occasion I examined the proposed transaction relatively thoroughly, and on the other occasions, only briefly. In each instance, I found several matters of concern:

1. The transactions were very complex and relied on the technical application of normal tax law provisions to facts that were contrived to produce tax results never contemplated by Congress.
2. The transactions involved very sizeable fees for professional advisors, investment bankers and others who promoted the transactions.
3. The transactions had either no business or economic purpose or a business or economic purpose that was dubious.

KCSI did not participate in any of the transactions presented to us, because of the lack of business and economic reality to the proposed transactions and our concern that a transaction constructed exclusively, or virtually exclusively, to generate tax benefits would not achieve such benefits.

Please do not interpret this statement as an indication that our company is not interested in controlling its tax cost or otherwise saving taxes where appropriate. In conducting our business and engaging in transactions undertaken for appropriate business purposes, we, of course, strive to pay no more taxes than the law requires and employ outside tax professionals to assist in achieving that goal. However, we

do not believe it is appropriate to engage in a significant transaction which is unrelated to a company's business principally or solely for the purpose of generating tax benefits. Such transactions are inconsistent with a self-assessing tax system and should be viewed as abusive and eliminated.

My concern about these transactions extends also to the way in which they have been developed and promoted. The transactions brought to my attention were not presented as business transactions with non-tax economic advantages. To the contrary, they were each promoted as a transaction that could reduce corporate taxes and for which an attempt would be made to find a business purpose. In several instances, the names of prominent local or national companies that had undertaken similar transactions were mentioned, presumably to add credibility to the proposal, but also creating pressure because of the increase in earnings a company could achieve through tax savings.

Tax professionals at accounting firms and law firms apparently have participated in designing these transactions and in promoting and executing them. On several occasions, the transactions presented to me were put forth as "proprietary," and prior to disclosure of the "proprietary" information, I was asked to agree not to undertake the transaction with other advisors. This approach raises other issues not now relevant (e.g., an attorney's obligation to use his or her expertise to assist each client who could potentially benefit from the "proprietary" information), but the point here is that tax professionals should assist in policing abusive transactions, not designing and promoting them to generate substantial fees.

Despite my belief that so-called corporate tax shelters are abusive and should be eliminated, I would like to express one significant concern regarding possible solutions to these transactions. Because of the nature of our current tax laws, these transactions present very complex issues cutting across many aspects of the Internal Revenue Code, and solutions aimed at specific transactions may be seen as only plugging one hole in the dike, while others continue to pop open. On the other hand, solutions that use very broad standards often require years for the development of regulations and possibly decades of litigation before meaningful rules are developed. Such broad solutions often establish traps for the unwary, result in unanticipated consequences and create enormous costs and burdens for our system of tax administration. Accordingly, broad, general solutions with vague language must be avoided. As I have indicated, we do not think the transactions presented to us would survive an IRS challenge under existing law, but I recognize that in a self-assessment tax system the IRS could easily be overwhelmed if there is widespread adoption of these abusive techniques, as seems to be occurring. Thus I think Congressional action is needed, at least to aide the Internal Revenue Service in detecting the use of such transactions, and probably also to clarify the anti-abuse rules now in the Code and those employed by the courts.

Thank you very much for the opportunity to appear before this Committee and offer comments on a very complex and important tax issue.

Chairman ARCHER. My gratitude to all of you gentlemen. Mr. Kies, your testimony seems to be different from Dr. Sullivan's, and I wonder if you could address the apparent differences between Dr. Sullivan's presentation relative to corporate tax receipts. Maybe I missed something, but I think there is some disparity between your two testimonies.

Mr. KIES. Mr. Chairman, there is—and, unfortunately, Marty and I haven't had a chance to actually explore this, but we have identified two very serious flaws in his analysis that I think indicate that the conclusion that he reached is factually incorrect.

In defining the corporate effective tax rate, he used corporate tax receipts and not the liability of corporations being reported year to year. Receipts and liability are two very different things. For a particular year, a corporation's liability could be a hundred million but there may be a variety of adjustments that occur that change the net tax receipts to the Federal Government because of receiving refunds from prior years or paying deficiencies from other years.

The other problem that we have identified with Marty's analysis is that his denominator includes a number of pieces of income that are not subject to the corporate income tax, including sub S corporation income, which he did identify, profits from Federal Reserve Banks, and also the failure to eliminate State or local income tax expense. These are all items that the Bureau of Economic Analysis backs out in calculating what are corporate profits.

We redid his numbers with these two adjustments, and what it shows is that, for 1999, the effective corporate tax rate is 32.7 percent. The average for '89 to '98 is 32.5 percent. Therefore, it would suggest that the effective rate expected for 1999 is well in line with the rate that we have seen over the past 10 years. The rate for '94 to '98 was 32.5 as well.

So our analysis with the modifications and the way we think the data should be analyzed suggest that the effective rate for this year is very consistent with what we have seen over the past 10 years.

We plan to provide the Committee with this detailed information. It wasn't possible to get it done in time for today because of how recently his article was published.

Chairman ARCHER. We will keep the record open for the receipt of that information.

[The information follows:]

November 30, 1999

The Honorable Bill Archer
United States House of Representatives
1236 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

I am writing to respond to a question you posed to me at the November 10, 1999, Ways and Means Committee hearing on "corporate tax shelters."

At the hearing, I stated that a claim made by Marty Sullivan of Tax Analysts regarding corporate effective tax rates was based on a seriously flawed methodology. Specifically, Mr. Sullivan testified that the corporate effective tax rate in FY 1999 is "too low by 1.5 percent, 2.5 percent, or 2.9 percent" compared to the prior three-, five-, and ten-year periods, respectively. You asked me to provide the Committee with information that supports my critique of Mr. Sullivan's claim.

Mr. Sullivan's measure of corporate effective tax rates is flawed for two main reasons. First, the "numerator" in his calculation is corporate tax receipts rather than corporate tax liability. The amount of corporate tax payments that Treasury receives during the year only partially relates to current-year tax liability. Many of the payments and refunds during the current year reflect adjustments to prior-year tax liability (e.g., audit adjustments, carrybacks of NOLs, etc.). Also, companies' tax payments for current-year liability are based on estimates, with final tax settlement typically occurring six to nine months after the close of the tax year. The proper measure should be corporate tax liability, data that is available from the IRS.

Second, the "denominator" in Mr. Sullivan's calculation is unadjusted corporate profits before tax, taken from the Commerce Department's GDP accounts. This is an inappropriate measure of corporate profits for purposes of calculating corporate effective tax rates. For purposes of calculating corporate profits, CBO makes four adjustments that Sullivan neglected:

(1) CBO subtracts profits of the Federal Reserve Banks;
(2) CBO subtracts profits of subchapter S corporations;
(3) CBO subtracts State and local income tax payments; and
(4) CBO adds corporate capital gains.

PricewaterhouseCoopers has calculated corporate effective tax rates using the proper methodology. First, the "numerator" we use is corporate tax liability as reported by the IRS or, for more recent years, estimated by the Commerce Department's Bureau of Economic Analysis. Second, the "denominator" (e.g., corporate profits), follows CBO's methodology, with the subtractions and additions discussed above. Making these corrections to Mr. Sullivan's work, we found that the corporate

effective tax rate in 1999 actually exceeds the average for the prior three, five, and ten years by between 0.2 percent and 0.3 percent.

CORPORATE EFFECTIVE TAX RATES

Year	Sullivan (fiscal years) percent	PwC (calendar years) percent
1999	21.8	32.7 [a]
1996–1998	23.3	32.4
1994–1998	24.3	32.4
1989–1998	24.7	32.5

[a] Based on first six months, seasonally adjusted.

In other words, there is no evidence that corporate effective tax rates are declining. Rather, the reverse appears to be true.

The Committee also should note that there is new evidence to support the view that the slight drop (2 percent) in net corporate income tax receipts in FY 1999 may simply be a statistical aberration, as Mr. Sullivan has acknowledged. Specifically, corporate income tax receipts in the first month of FY 2000 (October 1999) were nearly 25 percent higher than the first month of FY 1999 (October 1998). As I discussed at the hearing, we will continue to monitor the incoming data to weigh whether there is any real evidence to suggest that the corporate income tax base is in danger of eroding.

Sincerely,

KENNETH J. KIES

Chairman ARCHER. Dr. Sullivan, you want to make any comment?

Mr. SULLIVAN. Sure. I appreciate it.

I freely admit that these calculations are preliminary, that there are a lot of difficulties with them. That would only apply to my table number 3.

Tables number 1 and 2—I will talk about table 3. But tables number 1 and 2 are still unaffected by Ken's criticism.

Now let's go to table number 3. There is a—there are just a lot of—what I did, just so you know where I was coming from, I just chose the most commonly used profit figure. I did not fish or look around their search for the one that would produce the sexy result.

I think that this does deserve a lot of study. I think some of the shortcomings that Ken mentioned could go either way. That is, when you make all the corrections that you would like to see, maybe it would show more dramatic change or I think some of the shortfalls are not biased.

But the other factor is—and, again, is that even if it is level, that we would expect, with legislation, that it should increase. So, you know, it is always hard to know what the right answer is. But I just go back to the common sense of the first chart where corporate receipts are down, and we are not in a recession, and that is very unusual. And that is—otherwise, I agree with everything Ken said.

Mr. KIES. Just by way of clarification, we didn't fish around or otherwise for this data. We used what CBO uses as its methodology for computing the effective corporate tax rate, and we used what the Commerce Department's Bureau of Economic Analysis uses for its measure of liability. So, I mean, we used what we thought were fairly conventional numbers for purposes of making this analysis.

I would also point out that OMB predicted that corporate tax receipts would be down this year earlier this year because of the even-handed appreciation that is occurring because of significant investment increases that occurred in the past couple of years. This was a development that was predicted by the experts at both CBO and OMB, and they specifically noted that there was a dramatic increase in investment in the middle '90s over what had occurred earlier during the recession of the early '80s. And those depreciation deductions are now finding their way into the corporate revenve data.

Chairman ARCHER. Dr. Sullivan.

Mr. SULLIVAN. I just want to mention I don't know if I am disagreeing with you or not, Ken, but my understanding is that CBO predicted a downturn in corporate receipts due to their belief that corporate profits would decline, which has not been the case this year. So, in effect, they were at least partially right for the wrong reasons.

So, I do agree—I do agree with Ken. That is absolutely true that the increase in investment, as I mentioned in my article and in my testimony, may account for this. And I believe the Treasury in their testimony, they have much bigger economic models than I have, addressed that issue, and they didn't believe it was a problem.

Chairman ARCHER. When can we expect to get the final figures on 1999? These are just estimates right now.

Mr. SULLIVAN. It is a source of frustration to us. It is—it may take 3 years to get final figures on 1999. The numbers come cascading in, and they are continuously revised. So we each month get new data, and we make new estimates based on that.

Chairman ARCHER. Thank you very much.

Mr. Hariton, you mentioned perhaps an exception could be carved out for, I believe in your words, the little guy relative to whatever we do on tax shelters and that that would take care of the compliance costs. I must tell you, I am very concerned about the compliance costs of the entire code, irrespective of the size of the taxpayer. When we talk about spending as much on compliance as we spend on national defense each year, that should be a matter of concern for all of us. And so the compliance—any additional compliance costs that go beyond being able to really address the problem in this area would concern me.

You commented that the Treasury really just needs and the IRS just need more resources, and I agree with you on that. Our Committee does not set those resources, I am sorry to say, or they would have more. But the administration testimony today was that they can't administer this even with more resources when they don't know what is going on. I think that is pretty much what they said. So, if we gave them more resources and they come back and say doesn't matter, we don't know what is going on, we can't use them, what would your response do that be?

Mr. HARITON. Well, I guess one response I would make is we all know that Treasury is saying this in part, and it is only natural that they should say it, because the Treasury is requesting legislation. But the truth is Treasury is doing a marvelous job with the

resources it has—excuse me, the IRS is doing a marvelous job. It has a string of victories in court.

I can tell you as a lawyer that those victories are very valuable in advising a client the reason Mr. Carpenter's company is not investing in these Tax shelters not because it is an unusually moral company but rather because the company is properly advised, and the proper advice is these transactions do not work. And I can tell you that most companies take that very, very seriously.

You hear stories about how the CEO goes golfing with somebody that Representative Doggett might describe as a shyster, and the shyster tells her that there is some terrific deal where she can avoid all of her company's taxes. And of course that is incorrect as a matter of law. But none of us can stop that CEO from calling up the law firm of Winken, Blinken and Nod, if that is whom she wants to take her advice from. But the truth is that with decisions like this, it will become more and more clear even to that CEO that these transactions don't work as a matter of law. But what is clear is that if the IRS doesn't litigate these cases, and litigate them in force, and litigate them successfully, in effect as a practical matter the law has changed, the advice has changed, and then that CEO will do them more.

So I don't see any alternative for the Commissioner and any alternative for the Treasury Department but to litigate these cases as best they can. And if they succeed, new laws will be unnecessary. But if they fail, if they are not going to do it, I don't think any law that we put on the books is going to make one whit of difference.

I mean, think about it practically. We publish a definition of bad transactions and bad whisperings and it has 19 clauses and 3 subparts and 32 exceptions. Is anybody going to be walking around the golf course with that, with the CEO trying to tell her that the transaction in question does or does not fit that definition? No. Enforcement really is the answer of how to make sure people are really paying their taxes properly.

Chairman ARCHER. Are you saying then we have not yet realized the full impact of the remedial action that is already under way?

Mr. HARITON. As a practicing lawyer I can tell you that those court decisions have made a difference in the way people are behaving in the real world and that they will continue to make a difference in the way people are behaving in the real world. As I have said in my statement, I don't think that one should stop there. I think that Treasury and the IRS should have the maximum of resources because the task is two-fold and the hardest task is the first one, finding the transactions and distinguishing them with judgment and insight from legitimate business transactions. That is something that can only be done as a matter of administration and then telling these taxpayers those transactions don't work.

The second task is, for the few taxpayers who disagree, taking them to court, proving that you mean it, proving that the transactions don't work. If that happens on a consistent basis, the system will work, and you will find that people will not enter into these transactions.

Chairman ARCHER. Let me ask one last question which is a hypothetical, and first let me ask all of you, have you read H.R. 2255?

Does each of you have an understanding of what the bill does? Doc Sullivan says no, but that is not really what his job is here today. I understand that. What about you, Mr. Carpenter?

Mr. CARPENTER. I have only looked at a summary.

Chairman ARCHER. Mr. Hariton, you have looked at it, I take it; and, Mr. Kies, you have looked at it. I will ask the two of you this hypothetical question.

Let's assume this. That an individual has had a family corporation for a number of years and finally realized one day that their earnings are being double taxed; and they decide, hey, this doesn't make any sense. I don't know why I continue to have this family corporation. I am now going to have a partnership. And the corporation is dissolved so that the partnership earnings can flow out singly taxed to the owners rather than doubly taxed. Would I in any way be covered by this bill by taking that action?

Mr. KIES. Well, Mr. Chairman, I think you would be covered by the general terms of Mr. Doggett's bill which would indicate that any deduction exclusion that doesn't change the economic condition of the taxpayer could be disallowed. I would expect that Mr. Doggett and or the Treasury or IRS would take the position that that is something that ought to be covered by a specific exception, that is a result that is clearly anticipated by the law.

I think your question highlights a more fundamental point and that is that transactions as basic as the one you have described would have to be run through that continuous filter of are you or are you not a transaction that is contemplated by the law. And that is the biggest source of concern to us, that is like asking the IRS to completely rewrite the Internal Revenue Code through the prism of what is clearly contemplated rather than allowing taxpayers to rely on a body of law that has been built up over 75 years. And that really is the source of greatest concern about the nature of Mr. Doggett's proposal.

Chairman ARCHER. But the decision that was made in the hypothetical that I gave to you was solely for tax reasons. There was no change in the business transactions. It was driven solely for tax reasons and no other reason.

Would there have been a disclosure report required?

Mr. KIES. Again, I think it would depend upon how comfortable you were with either the statutory exceptions ultimately included in enactment of the provision.

Chairman ARCHER. But is that statutory exception included in this bill?

Mr. KIES. I think that is probably a matter of interpretation. But there is, I think, generally an exception that is intended to say if it is a result clearly contemplated by the Code—certainly, for example, the Treasury Department proposal has that exception—that you would be okay.

Again, it just highlights a more fundamental——

Chairman ARCHER. But under the terms of this bill, if you were advising me under this situation, would you advise me to file any kind of a disclosure?

Mr. KIES. You know, one would at least have to think about that. And if this were ever to be enacted into law, these question would be asked thousands of times over. What would become the stand-

ard of practice is very difficult to predict as we sit here with something that is pretty hypothetical, at least at this point.

Chairman ARCHER. Yeah, but this seems to me to fall exactly within the definition. There is no economic gain. This is strictly driven by taxes. And does that make it wrong?

Mr. KIES. Well, I don't think—as a matter of wrong or right, hopefully, one would not approach it that way. It would be a question if the statute clearly permits you to use your business form. And one would, therefore, presume that if you wanted to switch from being a C corp to a partnership or a sub S entity you should be permitted to do that. But, technically, it fits squarely within the general definition of what would be a targeted transaction.

Chairman ARCHER. Thank you very much.

And, Mr. Doggett, I am sure you would like to inquire.

Mr. DOGGETT. Thank you, Mr. Chairman. I am still seeking cosponsors, but you are not at the top of my list right now.

As far as your example, my answer would be that this legislation doesn't cover reorganizations and that the transaction you describe does not involve a loss, credit or deduction, so we don't even get to the enumerated provisions.

But I have a few questions for Mr. Kies.

Welcome back. When you were here on March the 10th, in response to questions that I asked, you indicated that you were opposed to Congress taking any legislative action on tax shelters whatsoever. Is that still your position?

Mr. KIES. Yes, Mr. Doggett. And I think intervening events just firm up that position because of the Tax Court cases that have shown——

Mr. DOGGETT. I appreciate that and would be glad for you to follow up in elaboration as to why. But since my time is limited, haven't you voiced the opinion yourself that Congress would, in fact, take no legislative action on tax shelters in this Congress?

Mr. KIES. I think what I have said is I didn't expect Congress would act this year on this issue.

Mr. DOGGETT. Are you familiar with the operations of your firm Pricewaterhouse with reference to the promotion of what some folks call tax shelter products?

Mr. KIES. I am familiar with the operations of our firm.

Mr. DOGGETT. What do these tax shelter products cost?

Mr. KIES. There is no specific cost.

Mr. DOGGETT. Just give me an idea of the range. The kind of tax shelter products that you would market, say, to a Fortune 500 company, what is the range of the cost of an individual tax product?

Mr. KIES. Mr. Doggett, perhaps you misunderstood my earlier answer. I said I am familiar with the type of advice we provide. I didn't say anything about marketing tax shelters. So if you want to rephrase your question I would be happy to answer.

Mr. DOGGETT. Are there any tax products that you sell to corporations in this country, large corporations, in order to permit them to reduce significantly the amount of their taxes? And, if so, can you tell me what those kind of products cost?

Mr. KIES. The costs would be totally dependent on the complexity.

The answer to your first question is, we advise clients with respect to ways in which to legitimately reduce their tax liability with some things as simple as their capital structure in using debt instead of equity, which gives rise to interest deductions, and then there are much more complicated transactions involving corporate reorganizations. The level—the fees involved would be directly related to the complexity.

Mr. DOGGETT. Mr. Kies, do you know Mr. Fernando Murias, the co-chair, as of 1998, of the firm's Mid-Atlantic and Washington national tax practice?

Mr. KIES. Yes, sir, I do.

Mr. DOGGETT. Is he still employed after he gave that Forbes interview?

Mr. KIES. Mr. Morias is still a partner with the firm. That is correct.

Mr. DOGGETT. Is he still the director of the Mid-Atlantic and Washington National Tax Practice?

Mr. KIES. No, he is not.

Mr. DOGGETT. And when did that change?

Mr. KIES. He took a different position within the last 6 or 8 months.

Mr. DOGGETT. And, as you know because we talked about this some when you were here in March, he told Forbes that your company has actively promoted about 30 mass market products, and for each had prepared a marketing briefing book and assigned product managers called ''product champions'' to coordinate sales, and that you had 40 newly hired professional salesmen helping pitch these ideas to companies that aren't current clients. Was he accurate in that regard?

Mr. KIES. Mr. Doggett, I think the words that Mr. Morias chose, which were at a cocktail party, were rather inartful. The reality——

Mr. DOGGETT. Were they inaccurate?

Mr. KIES. They were both inartful and inaccurate. What is a fact is that the firm does identify planning strategies from time to time that may have common application to more than one client and under those circumstances it wouldn't be surprising that we might share those with potential clients.

Mr. DOGGETT. What is the range of the cost of those 30 mass market products that he referred to?

Mr. KIES. I really don't know.

Mr. DOGGETT. Would you be able to supply us that information?

Mr. KIES. It is possible.

Mr. DOGGETT. Will you make an effort to do so?

Mr. KIES. Certainly.

Mr. DOGGETT. It is a profit center for the company that I suppose is growing and is substantial, isn't it?

Mr. KIES. Not really, Mr. Doggett.

Mr. DOGGETT. Since we are on the caution light, let me ask you about another comment that he made, that your firm markets so-called ''black box'' products. I asked you about that in March and you indicated you weren't familiar with it. These, he is quoted as saying, ''are complex and unique strategies that we do not publicize broadly.'' Each can save a client from tens of millions to hundreds

of millions of dollars in tax. Has your company marketed such products?

Mr. KIES. Mr. Doggett, again, I think the words Mr. Morias used were both inartful—it is certainly true that we have planned transactions for clients that may have substantial tax savings like doing a tax-free re-organization instead of a sale of a subsidiary.

Mr. DOGGETT. Never heard of them referred to as "black box" proposals?

Mr. KIES. The term black box——

Mr. DOGGETT. Do you have some proposals, as he says, that you don't publicize broadly and you save for a few select clients?

Mr. KIES. Mr. Doggett, perhaps you could indicate which question you would like me to answer.

Mr. DOGGETT. The latter one, the one I just asked. Would you like me to restate it?

Mr. KIES. You asked me whether or not we use a black box. And then, as I tried to give that answer, you interrupted me. Maybe you just tell me which question you would like me to answer.

Mr. DOGGETT. I would glad to, if the chairman would permit.

Mr. MCCRERY. I would indulge the gentleman one last question.

Mr. DOGGETT. Thank you. It is because of the danger of filibuster that I have tried to ask these questions succinctly.

Let me ask you, sir, if, as one last question only, if your company is still promoting the bond and option sales strategy that you call the Boss plan, a way to circumvent what this Committee did on section 357 in June.

Mr. KIES. I am not even familiar with that transaction. I would be happy to look at it and get back to you.

Mr. DOGGETT. I am sure you would. It has got PricewaterhouseCoopers on the cover, so I am sure you can find out about it when you get back.

Thank you for your responsiveness, Mr. Kies.

Mr. KIES. Certainly, Mr. Doggett.

[The information follows:]

[The Bond and Option Sales Strategy (Boss) plan is being retained in the Committee files.]

December 20, 1999

The Honorable Bill Archer
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515–6348

Dear Mr. Chairman:

At the November 10, 1999, Ways and Means Committee hearing, Rep. Lloyd Doggett (D–TX) asked me for further information with respect to matters regarding my firm, PricewaterhouseCoopers. This letter is my response to Rep. Doggett's request, and is being sent to you so that it may be included in the printed record for the hearing. I am forwarding a copy of this letter to Rep. Doggett.

Rep. Doggett asked me then if my firm is promoting a so-called "Bond & Option Sales Strategy" transaction. At the time of his question, I was not familiar with this transaction, as I stated at the hearing. Since the hearing, I have inquired within my firm about this matter. I also requested, and received from Rep. Doggett's office, a copy of a summary document apparently generated by PricewaterhouseCoopers regarding this hypothetical transaction and a draft of an opinion letter regarding the tax consequences of the Bond & Option Sales Strategy.

I have learned the following. First, it is my understanding that PricewaterhouseCoopers has not been engaged by any client to assist, advise, or oth-

erwise consult on execution of the specific Bond & Option Sales Strategy transaction outlined in the draft opinion letter that Rep. Doggett provided. Second, we did advise clients with respect to transactions similar to the one described in the draft opinion involving different economic characteristics. Third, it is the position of my firm that we will not issue an opinion on this transaction or such similar transactions. Moreover, we have delivered no such opinions to any client.

Rep. Doggett also asked me about the fees charged by PricewaterhouseCoopers in conjunction with the tax advice that we provide to clients. Specifically, Rep. Doggett asked about the cost of the "30 mass-market products" that our partner Fernando Murias was quoted in the December 14, 1998, edition of Forbes magazine as saying my firm offers. Mr. Murias believes that his quoted comments were taken out of context and my firm does not believe they accurately portray the firm or its practices.

In response to Rep. Doggett's question, I am not aware, as an initial matter, which specific services provided by PricewaterhouseCoopers were referred to by Mr. Murias. Even if I was, the fees charged by my firm are held confidential with our clients, and I would not be in a position to provide any specifics. That said, it is true that my firm consults regularly on ways to minimize our clients' tax liability consistent with Federal, State and local, and international tax laws. It also is true that some of these strategies have general applicability across our client base (e.g., reviewing a company's tax accounting methods) and in that regard we offer these services broadly. Other services we provide are specific to a client's unique facts and circumstances (e.g., consulting on a corporate reorganization) and thus are not applicable to a "mass market." While there are no standard fees charged by my firm with respect to our services, in all cases the firm's fees are consistent with fees charged by other professional tax advisors and consistent with the expectations of our clients.

SINCERELY,
KENNETH J. KIES

cc: The Honorable Charles Rangel, Ranking Minority Member, Committee on Ways and Means, U.S. House of Representatives
The Honorable Lloyd Doggett, U.S. House of Representatives
Jim Clark, Chief Tax Counsel, Committee on Ways and Means, U.S. House of Representatives
John Buckley, Minority Tax Counsel, Committee on Ways and Means, U.S. House of Representatives
Lindy Paull, Chief of Staff, Joint Committee on Taxation
Jonathan Talisman, Acting Assistant Secretary (Tax Policy), Department of the Treasury

Mr. MCCRERY. Mr. Kies, there were a number of questions asked. I would be willing to give you time now to respond to those questions if you so choose. If not, I have questions of my own.

Mr. KIES. I would be happy to answer your questions, Mr.McCrery.

Mr. MCCRERY. Thank you.

Mr. Hariton, I was most interested in your comments about Treasury employees and paying them more because of the expertise needed. In fact, I think we could extend that maybe to the Ways and Means Committee. We will talk about that later. What about disclosure requirements? You didn't seem to be in favor of much of anything except letting the courts continue to work their magic. What about disclosure requirements? Do we need more disclosure requirements?

Mr. HARITON. We have the same difficulty I fear with disclosure requirements that we had with substantive requirements which is, in order to have them, we have to figure out what a corporate tax shelter is. It is all very easy to say, well, disclose anything that is a corporate tax shelter. And if you read, for example, the proposals

of Mr. Sax at the ABA, there is a long and detailed disclosure signed by the CFO with a great deal of ceremony. But it turns out, as the chairman was suggesting earlier, that when you go to figure out what transactions this applies to, it turns out to apply to everything and nothing. So that, if properly advised, basically we are enacting a rule that says every transaction done in America has to be disclosed in detail by the CFO and signed.

Now—and you might well ask, who is going to write all those disclosures? And when they arrive in Washington who is going to read them? And what are they going to do with them? That might all be rather funny in a way, if it weren't that we all understand as practical people that none of that is ever going to happen. The minute you enact that law it will be ignored and nobody will disclose anything because they can't understand what they are supposed to disclose. So what it will reduce to is that if and when the IRS enforces a tax-abusive transaction, one of the things that they will say is that you should have disclosed.

So to me we might as well go right to the heart of the issue and talk about the penalties that are imposed on persons who are found to have engaged in corporate tax shelters. I do not object, as I said in my statement, or think it would be a mistake to propose, for example, to raise the penalty for understatements arising from corporate tax shelter transactions if Congress feels that the balance is misplaced. I simply do not want Congress to enact legislation that on its face, after some careful thought, cannot possibly help in any way.

Mr. MCCRERY. Why do you think the American Bar Association and the New York Bar Association are so seemingly adamantly in favor of increased disclosure requirements?

Mr. HARITON. Well, everybody involved in this process I feel means well, and I can't speak to where anybody comes to their——

Mr. MCCRERY. I am not talking about their motive. I am talking about why the difference. Why are such respected organizations as the ABA and the New York Bar in favor of increased disclosure and you make such compelling arguments against it? How do you explain that? What compelled them to reach such a different conclusion?

Mr. HARITON. Well, I cannot—again, it is impossible for me to say—I haven't had enough discussions with Mr. Sax, for example, to get the full benefit of his reasoning and perhaps I should.

I can tell you myself, based on my 15 years of experience in advising about the tax consequences of complex business transactions, that it is impossible, as the chairman was suggesting earlier, to give anybody any advice about what would or would not be disclosable, right down to the fellow who is disincorporating to avoid a second-level tax.

I can tell you, for example, that many of the transactions that were done you would not think were tax abusive but were shut down by Congress presumably would be picked up—for example, Mirror Liquidations in the 1980s or just recently the so-called Morris Trust Transaction that was closed down, that is a spin-off followed by a merger of one of the companies into another company. Were these all disclosable transactions?

In a sense, the disclosable transactions would really be infinite. And I don't understand how we would all function on a going-forward basis if we were to take seriously rules that say disclose any transaction with a significant purpose of tax avoidance. That is what I do for a living, is spend my time trying to figure out how to structure transactions so that you pay less rather than more tax. I do not want to—I think it would be a mistake for Congress to enact a law which, because it couldn't be complied with, encourages taxpayers and their advisors to ignore the law.

Mr. MCCRERY. Is there anything—I will let you add to that in just a minute.

Is there anything that enhanced disclosure requirements would offer the IRS that they don't now have access to in an audit?

Mr. HARITON. For practical reasons I honestly don't think so. And here is the practical reason: In order to make use of a disclosure, one must examine it, ponder, think and analyze. There is no machine down here in Washington that can receive disclosures and sort them out in a pile, one abusive, nine okay, one abusive, nine okay. And this takes time. That is administration. That is why administration is the only answer to the problem.

Mr. MCCRERY. Mr. Kies.

Mr. KIES. Mr. McCrery, with all due respect to the previous panel, it did not appear to me and it does not appear to me that either the New York Bar or the ABA tax section have actually taken the time to analyze the economic data as to whether there is a problem with the erosion of the corporate tax base. I think they are operating largely based on anecdotal experience.

If you noted, the last panel couldn't even identify what is the current level of corporate revenues. The only number thrown out was $120 billion. The current level, as you can see, is $180 billion. And I would have to just respectfully say that I don't think either one of those organizations have taken the time to examine the actual macro-economic data as to where corporate revenues have gone over the last 10 years to determine whether there is any fundamental erosion of the corporate tax base underway.

We believe that is a threshold question that needs to be answered before one is launched off into a lot of statutory changes, particularly when you realize that the Service has been quite successful in combating problems within the last year through a series of Tax Court decisions that have been favorable to the government.

I think Mr. Hariton noted something earlier I would just underscore in this regard and that is corporate tax directors and corporate professionals are reading those cases quite closely, and it is foolish to think that they are not taking into account the direction the courts are going in how they advise their clients. Because they clearly are.

Mr. MCCRERY. Dr. Sullivan, I was somewhat surprised at your conclusion that there is a trend of declining corporate tax revenues to the Federal Government. And I was surprised because I immediately—before listening to your testimony, I read the charts provided by Mr. Kies which indicate that, as a percent of GDP, corporate revenues have actually increased since the early '80s, fairly consistently. And only this year, 1999, did we see a decrease from 2.2 percent of GDP to 2.1 percent of GDP.

In light of—first of all, maybe these are wrong, but if you don't think they are wrong, then does that change your conclusion or do you still stand by your conclusion that we have a trend of declining corporate tax revenues?

Mr. SULLIVAN. Yes, I do. The reason is that corporate—we—just put it simply, we had surging—we haven't noticed this trend because the Treasury has been doing so well with so much money coming in. And the question is relative to the amount of corporate profits we should expect.

I was surprised to find this result myself. But when you look at corporate profits and you look at how much they have gone up, you just say receipts haven't gone up commensurate with that. And that is what is surprising.

You look at the order of magnitude, and if you—depending on what type of chart you look at, it may look small, but it could be—it easily could be a 10 or $20 billion shortfall. It could be more than that.

Again, that is why I think it is important that the Committee at least be aware of this with all the uncertainty around it that there might be this problem. I wouldn't want to you come to me 2 years from now and say, why didn't you tell me about this? There is something going on. We are not sure.

If I may just add, it is very reminiscent of about 10 years ago when foreign corporations doing business in the United States were not paying any tax. We could clearly see that in the data, but we didn't know why. The inference was in transfer pricing, and we had a big to-do about transfer pricing. It is really the same situation here. We are observing something going on, we will never be able to prove it by looking at the data, but we just need to keep that in mind as we look at the overall situation.

Mr. MCCRERY. Mr. Kies, do you have any comment on that?

Mr. KIES. I would just cite you to our data, which really does show, I think rather convincingly, corporate revenues are on an up trend. There may be this small downturn for this year, which I think is easily explainable because of depreciation. But when you look at a number of factors like corporate revenues as a percent of GDP, when you look at effective tax rates, the effective tax rate for this year is expected to be 32.7 percent. That is well in line with what we have seen over the past 10 years. It is higher than we saw in 1980 when it was only 29.2 percent.

But I would say, consistent with Mr. Sullivan, and that is you should continue to watch these numbers to determine whether there is some fundamental problem. I guess what we are saying is we don't see it in the numbers that we have to date, that the corporate revenue base appears to be quite vibrant and has been for the past 10 years. But certainly part of the Committee's responsibility is to continue to monitor that situation.

Mr. MCCRERY. Yeah, I have to say I think we should monitor them, but I am not inclined to agree with Dr. Sullivan that there is a trend out there right now. Maybe if we get another 2 or 3 years of declining corporate receipts as a percent of GDP then we could conclude that there is. But, right now, I am inclined to say just watch it.

Mr. Carpenter, you seem to be saying that there should be more focus on the folks advising corporations and individuals on tax shelters. Are you suggesting that we ought to consider penalties for people who are advising corporations and individuals to enter into these illegal transactions?

Mr. CARPENTER. I think that some bolstering of Circular 230 probably is in order. I am not an expert in the area, but I do believe that is appropriate.

However, I do not believe that going after the promoters or the advisors is the ultimate answer. If there are no tax shelters to promote, there will be no promoters. So I do believe that in some fashion or another there should be an effort made to reduce the attractiveness or reduce the availability of the so-called corporate tax shelters.

I think that some further disclosure would be appropriate, and think that possibly some changes in the anti-abuse sections would be appropriate. Particularly I think that consideration could be given to modifying the rules on reasonable cause under Section 6664 so that there is an explicit exclusion for certain opinions that are faulty or not-well-reasoned tax opinions. I know such changes can get into a lot of issues, but I do think that there are some possibilities there.

I think there is also a possibility that one should consider making the reasonable cause exception of 6664(c) available only to transactions that are disclosed.

So I do think there are things that can be done that aren't massive that would help put a chilling effect on these corporate tax shelters. I don't think that actions through the courts by themselves will do that, because it takes a long time. And the shelters that are being sold now are very complex, and they are based, to a certain extent at least, on confidentiality and the anticipation that the transaction will not be discovered in audit. So that is the reason I think some attention of this Committee is appropriate to these matters, and hopefully a workable solution can be found.

Mr. MCCRERY. Are you not concerned about the costs to your company of complying with such disclosure requirements?

Mr. CARPENTER. I am very concerned about it, but I am also concerned that the fact that the rates that every taxpayer pays are higher if others are avoiding tax in ways that are not contemplated by the laws of this country.

So, yes, I do have some concern about the compliance costs. I definitely am concerned about any rules that would require taxpayers to do something within 30 days. I think that is a very difficult compliance requirement that should not be enacted if it is being proposed. Compliance is a very difficult process in a large corporation or for any taxpayer, and it is difficult enough to pull all of the needed resources together to do an annual tax return. But to have various rules requiring compliance within a 30-day period after a transaction I think definitely should be avoided.

Mr. MCCRERY. I know you have said you have only read a summary of Mr. Doggett's bill. Would you be so kind as to have someone on your staff look at it more carefully and advise us of particularly the disclosure section of his legislation and see if you think

that is a reasonable requirement or if it is too onerous or just what your comments would be? I would appreciate that.

Mr. CARPENTER. I would be very happy to do that.

[The information follows:]

November 30, 1999

The Honorable Jim McCrery
United States House of Representatives
2104 Rayburn House Office Building
Washington, DC 20515–1804

Re: Corporate Tax Shelters

Dear Congressman McCrery:

This letter responds to your request at the Ways and Means Committee hearing on corporate tax shelters held on November 10, 1999. Specifically, you requested that I consider the disclosure provisions of the "Doggett Bill" (H.R. 2255) and offer my perspective about the reasonableness of those proposed disclosure requirements. I now have had a chance to review the Doggett Bill in full and offer the following comments on the disclosure provisions of that bill:

1. I strongly oppose any disclosure requirement other than a disclosure in the tax return of the taxpayer for the year in which the transaction takes place. Requiring disclosure within 30 days of a transaction is an unnecessary burden on the taxpayer (annual returns and quarterly payments are all that should be required), and would be useless unless the IRS is given large additional resources to scrutinize such disclosures.

2. The Doggett Bill would require taxpayers to disclose "appropriate documents describing the transaction." This requirement is vague, thus creating uncertainty for taxpayers attempting to comply and also allowing taxpayers great latitude in their disclosures, resulting in significant IRS time to analyze the disclosures.

3. The Doggett Bill also would require very extensive information to be filed with the taxpayer's return, which probably is more information than the IRS would find useful or economical to analyze at that stage. Obviously, all of the details would have to be provided to the IRS on audit, but I hope that there could be simpler tax return disclosures that would be more useful to the IRS.

For the initial tax return disclosure, simple disclosure of the salient facts would be preferable to the more burdensome Doggett Bill disclosure provisions. Because any definition of a corporate tax shelter probably should consider the relationship between any economic benefits and the anticipated tax benefits from the transaction, a simple disclosure requirement could include only (a) a brief description of the transaction, (b) a disclosure of the transaction as a corporate tax shelter for ease in identification by the IRS, and (c) a comparative disclosure of the economic and tax benefits for the tax year in question and an estimate of such benefits over the next ten years.

It is a pleasure to have this opportunity to provide a follow-up to the November 10 hearing.

VERY TRULY YOURS,

DANNY R. CARPENTER

Mr. MCCRERY. Mr. Doggett, we have a vote on. Thank you all very much for appearing before us today, and we look forward to working with all of you to address this situation. Thank you.

[Whereupon, at 3:20 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

November 5, 1999

The Honorable Bill Archer
Chair
House Ways & Means Committee
House of Representatives
Washington, DC 20515

The Honorable William V. Roth, Jr.
Chair
Senate Finance Committee
United States Senate
Washington, DC 20510

The Honorable Charles B. Rangel
Ranking Minority Member
House Ways & Means Committee
House of Representatives
Washington, DC 20515

The Honorable Daniel P. Moynihan
Ranking Minority Member
Senate Finance Committee
United States Senate
Washington, DC 20510

Charles O. Rossotti
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, N.W.
Washington, DC 20224

Jonathan Talisman
Acting Assistant Secretary, Tax Policy
Department of the Treasury
Room 3120
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Dear Sirs:

We are writing to express our views on the provisions regarding corporate tax shelters contained in the Administration's Fiscal Year 2000 Budget Proposals (the "Administration Proposals"), which were released in February of this year, along with proposed modifications contained in the Treasury Department White Paper on "The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals" (the "White Paper"), which was released on July 1, 1999. Our comments are limited to the proposals relating to "tax shelters" generally, as opposed to the provisions in the Administration Proposals addressing specific perceived abuses, such as the proposal to modify the anti-abuse rules related to assumption of liabilities in transactions under Section 351 of the Internal Revenue Code of 1986, as amended (the "Code").[1]

As discussed in more detail below, we share the Treasury Department's concern about the recent proliferation of corporate tax shelters and understand the motivation behind the Administration Proposals, as modified by the White Paper (as so modified, the "Treasury Proposals"). In this regard, we generally endorse the proposals for enhanced disclosure requirements and the increase in the "substantial understatement" penalty applicable to corporate tax shelters. However, we differ from the Treasury Department insofar as we believe that all existing tools for enforcement, along with enhanced disclosure requirements and penalties, should be utilized before attempting to combat these perceived abuses by permitting the Internal Revenue Service to disallow tax benefits based upon characterization of a transaction as a "tax avoidance transaction," without regard to the normally applicable substantive provisions of the Code. We also disagree with the provisions in the Treasury Proposals that target not just the corporate taxpayers seeking benefits from "tax shelters," but the advisers and tax-exempt parties involved in these transactions.

[1] This letter also addresses certain similar provisions in H.R. 2255, the proposed "Abusive Tax Shelter Shutdown Act of 1999," which was introduced on June 17, 1999.

CONCERNS WITH THE GENERAL APPROACH OF THE TREASURY PROPOSALS TO DENYING TAX BENEFITS ASSOCIATED WITH "TAX SHELTERS"

The Treasury Proposals would disallow tax benefits associated with transactions in which the reasonably expected pre-tax benefits are insignificant in comparison to the reasonably expected net tax benefits, as well as certain financing transactions.

We agree with the Treasury Department's concerns about the aggressive marketing of corporate tax shelters, which has resulted in a great deal of publicity not only in the tax press, but in the general business press.[2] Although corrective regulations or legislative amendments have been proposed to rectify many of the alleged abuses after they have come to light,[3] the Treasury Department apparently fears that abusive transactions that have already taken place will be grandfathered by specific regulatory and legislative remedies and that other transactions will go undetected. As a result, the Treasury Department apparently believes that a more general anti-abuse rule will give the Internal Revenue Service the ability to more effectively prevent and combat abuses.

We concur with the Treasury Department that heavily promoted corporate tax shelters, which often have little or no non-tax economic motivation and rely on very aggressive, and often dubious, technical interpretations of the Code and regulations, pose serious problems for the tax system. Even aside from the potential for corporations to realize tax savings that are unwarranted from a policy standpoint, publicity about these transactions creates a damaging public perception that the tax system is unfair.

Nonetheless, we are not convinced that the approach to disallowing tax benefits taken by the Treasury Proposals is warranted. This is particularly so in light of what appears to be a lack of empirical evidence as to the amount of revenue that has been lost by the Treasury due to claimed tax benefits that would be disallowed under the Treasury Proposals but are otherwise allowable. Our sense is that many of the aggressive tax-motivated transactions currently being marketed are vulnerable to attack under present law, as a result of which many taxpayers that have been approached by investment bankers and other promoters have decided against proceeding with these transactions. The Internal Revenue Service's potential ability under current law successfully to attack abusive transactions that actually have been implemented further complicates any effort at producing meaningful revenue estimates of the impact of the Treasury Proposals.

The Treasury Proposals, insofar as they would disallow tax benefits arising from a broadly defined class of tax avoidance transactions, represent a significant departure from current law. The proposed anti-tax shelter rules clearly go well beyond existing anti-avoidance provisions of the Code and regulations, such as Treas. Reg. § 1.1502–13(h), that are limited to preventing attempts to avoid the purposes of specific substantive rules. The scope of transactions potentially covered by the Treasury Proposals is far broader than Section 269 of the Code, which addresses only limited types of acquisitions of corporate control and carryover basis acquisitions of assets undertaken with the principal purpose of obtaining tax benefits that would not otherwise be available. Even the partnership anti-abuse regulations of Treas. Reg. § 1.701–2, which are extremely broad and have themselves been the subject of substantial criticism, are at least on their face limited to transactions that are deemed to be inconsistent with the intent of Subchapter K of the Code. By contrast, the Treasury Proposals' anti-tax shelter provisions are not limited to transactions which are inconsistent with the generally applicable substantive rules of the Code and regulations or with the intent of such rules. The Treasury Proposals also go significantly beyond the existing judicial economic substance and business purpose doctrines. These doctrines are generally understood to apply only to transactions that are devoid of any economic substance or business purpose. The Treasury Proposals, on the other hand, would require a vaguely defined weighing of tax and non-tax motivations.

Our most fundamental objection to the Treasury Proposals' anti-tax shelter provisions is that they would create enormous uncertainty and would have a chilling effect on transactions that incorporate entirely appropriate tax planning. Tax considerations play a major role in many business decisions. The U.S. business and financial environment is extremely complex, which has inevitably resulted in the development of an equally complex set of tax laws. Nonetheless, with sufficient effort, it generally is possible to reach a reasonable level of confidence as to the tax con-

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[2] *See, e.g.*, the cover story in the December 14, 1998 edition of Forbes.

[3] *See, e.g.*, Notice 97–21 and Prop. Treas. Reg. § 1.7701(l)–3 (addressing fast-pay stock); Section 3001 of Pub. L. 106–36 (modifying applicability of Section 357(c) to asset transfers subject to liabilities).

sequences of a given set of actions. This level of certainty, which is extremely important to business planning, would be severely undermined by enactment of the Treasury Proposals. The anti-tax shelter provisions would permit the Internal Revenue Service to override the generally applicable substantive tax rules based upon inherently uncertain assessments of the likely pre-tax and tax benefits to be derived from a transaction or the perceived propriety of reductions in income.[4] As a result, there would be a serious risk that legitimate tax planning in the context of *bona fide* business transactions would be frustrated.

We believe that abusive tax shelters can be more effectively and appropriately combated through a more traditional approach along with increased penalties and stepped-up enforcement. Addressing specific provisions of the Code and regulations ultimately is a more effective way of addressing abusive transactions because it produces more predictable results. In addition, because many corporate tax shelters are designed to take advantage of provisions that, in other contexts, can produce results that are unfairly detrimental to taxpayers, an approach that corrects the distortions that produce these results can enhance the overall fairness of the tax system and benefit taxpayers as well as the government. Moreover, although we recognize that changes to legislation and regulations may not be effective with respect to transactions that have already been consummated, many such transactions, if they are perceived as abusive corporate tax shelters, can be attacked successfully through vigorous enforcement of current law.

Not only can the Internal Revenue Service challenge transactions using technical arguments that may be available with respect to specific provisions of the Code and regulations, under current law it can avail itself of arguments such as the business purpose, economic substance, and substance over form doctrines and the clear reflection of income principle. The government successfully used this approach in a number of recent cases, including *ACM Partnership* v. *Commissioner*, 157 F.3d 231 (3rd Cir. 1998), *Compaq Computer Corp.* v. *Commissioner*, 113 T.C. No. 17 (1999), *Winn-Dixie Stores, Inc.* v. *Commissioner*, 113 T.C. No. 21 (1999), and IES Industries, Inc. v. *United States* (N.D. Iowa, No. C97–206, 1999). These cases are clear examples of effective actions by the Internal Revenue Service to combat perceived abuses under current law.[5] Significantly, the Internal Revenue Service in all of these cases successfully attacked transactions raising issues which had also been effectively addressed on a prospective basis by administrative or legislative actions.[6] These cases thus cut against the assertion by some advocates of the Treasury Proposals that "piecemeal" changes in the law are inadequate because prior transactions are grandfathered and go unchallenged.

The Treasury Department can also reduce the risk that corporate tax shelters will go undetected by promulgating regulations to implement the 1997 changes to the tax shelter registration requirements of Section 6111 of the Code. Perhaps more fundamentally, we believe that the Internal Revenue Service should be given adequate resources to support its enforcement activities. One of the factors weighed by taxpayers in deciding whether to enter into aggressive tax-motivated transactions is the likelihood of being audited. The better the enforcement of existing rules, the higher the likelihood of audit, and the less likely taxpayers are to enter into abusive transactions. A reversal of the recently reported drop in audit activity[7] would go a long way toward not only combating tax shelters, but increasing compliance in non-shelter situations.

SPECIFIC COMMENTS ON THE TREASURY PROPOSALS

Although the Treasury Proposals have not yet been reduced to specific legislative language, their description in the "General Explanations of the Administration's Revenue Proposals" (the "General Explanation") and the White Paper gives rise to a number of troublesome issues.

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[4] This is, of course, a one-way street. Taxpayers would not be given a similar right to insist on a deviation from the normal rules where they result in some "unfair" or "irrational" negative result. Although taxpayers can often plan their affairs and structure transactions in such a way as to avoid these adverse outcomes, this is not always possible even for well-advised taxpayers.

[5] In *Compaq*, the government prevailed not only in disallowing the claimed tax benefits, but in assessing a negligence penalty.

[6] ACM involved use by the taxpayer of provisions in the installment sale regulations which the Internal Revenue Service announced in Notice 90–56, 1990–2 C.B. 344, would be amended. *Compaq* and *IES Industries* involved claims of credits for foreign taxes withheld from dividends on stock held for periods that would have fallen short of the subsequently enacted holding period requirements of Section 901(k) of the Code. *Similarly*, in *Winn-Dixie*, the court disallowed claimed interest deductions arising from a corporate-owned life insurance program of a type that was addressed in post-transaction amendments to Section 264 of the Code.

[7] See Tax Notes, April 12, 1999, p. 188.

Definition of "tax avoidance transaction."

The Treasury Proposals generally are aimed at "tax avoidance transactions," a term that includes two general categories of transactions. The first category includes "any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction."[8] Under the original Administration Proposals, the definition of a tax avoidance transaction would also have included certain transactions involving "the improper elimination or significant reduction of tax on economic income." The White Paper would replace this second category of the tax shelter definition with an additional category of tax avoidance transaction similar to that set forth in H.R. 2255. This new second category would encompass financing transactions in which the deductions claimed by the taxpayer for any period are significantly in excess of the economic return realized by the person providing the capital.

This definition is extremely problematic to the extent that it would be employed to disallow otherwise allowable tax benefits, thus affecting taxpayers' underlying tax liabilities, as opposed to merely serving as a benchmark for the imposition of penalties with respect to benefits that are otherwise disallowed. At the most basic level, it is totally unclear what it means for the reasonably expected pre-tax profit to be "insignificant" relative to the reasonably expected net tax benefits. "Insignificant" could mean less than 40 percent, less than 25 percent, or even less than 10 percent. Given that every dollar of deductible expense in the most straightforward transaction results in a thirty-five cent tax savings for top-bracket corporate taxpayers, the threshold of "insignificance," if set too high, is very quickly met. Moreover, in most business transactions, the "reasonably expected pre-tax profit" is extremely difficult to predict, and the relationship between pre-tax profit and net tax benefits often is highly dependent upon the success of the venture.

The proposed definition of tax avoidance transaction has substantial potential for overbreadth. The economics of many straightforward commercial transactions, such as "plain vanilla" leveraged leases of aircraft to domestic airlines, which are heavily dependent upon tax savings and often produce returns without regard to tax consequences that are less than returns on "risk-free" investments in United States government obligations, might fall within the first category of the definition of a tax avoidance transaction, despite the fact that such arrangements generally are not perceived as abusive tax shelters. Many internal restructurings of corporate groups intended to enhance tax efficiency would also appear to fall within the literal terms of the definition, because there often is no pre-tax motivation. Similarly, a sale of a high basis, low value asset at a loss could produce tax savings substantially in excess of any pre-tax economic benefit. The Treasury Proposals do provide that a "tax benefit," while including "a reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund," excludes "a tax benefit clearly contemplated by the applicable provision (taking into account the Congressional purpose for such provision and the interaction of such provision with other provisions of the Code)." The scope of this exclusion is, however, extremely uncertain. It can be argued that any tax benefit expressly provided in the Code must have been "clearly contemplated," but this presumably is not what was intended by the Treasury Proposals, because they then would be rendered almost completely meaningless. On the other hand, it can equally well be argued that very few tax benefits are "clearly contemplated" in the context of a particular transaction, since Congress typically promulgates rules of general applicability rather than rules aimed at specific transactions. The White Paper attempts to provide some assurance by enumerating the low-income housing credit and deductions generated by "standard leveraged leases" as examples of benefits that normally would meet the tax avoidance transaction definition but are not subject to disallowance.[9] Even this apparent concession, however, is limited by a statement to the effect that tax benefits generated by leveraged leasing activity require careful analysis as to whether such benefits are clearly contemplated and that some such transactions may indeed be tax avoidance transactions.[10]

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[8] H.R. 2255 includes a similar definition of "noneconomic tax attribute," which would include any deduction, loss, or credit arising from any transaction unless the transaction changes the taxpayer's economic position (apart from federal income tax consequences) in a "meaningful way" and the present value of the reasonably expected potential income (and risk of loss) from the transaction is "substantial" in relationship to the present value of the tax benefits claimed.

[9] White Paper, p. 96.

[10] *Id.*, n. 35

The portion of the definition dealing with financing transactions is also troubling. As with the first prong of the definition, there is a great deal of pressure on determining the "significance" of a discrepancy between the taxpayer's deductions and the capital provider's economic return. A further flaw is that the definition picks up transactions where there is a discrepancy for any period rather than looking at the life of the transaction. Finally, categorizing a financing transaction as a tax avoidance transaction is fundamentally unfair where the discrepancy between the taxpayer's deductions and the capital provider's economic return results from application of tax accounting principles embodied in the Code or regulations, especially where the capital provider is a U.S. taxpayer and suffers income inclusions that match the taxpayer's deductions.

Finally, it appears that the determination of whether a given transaction is a tax avoidance transaction is highly dependent on how the transaction itself is defined. This is a particularly difficult issue in the case of multi-step transactions, which can be viewed either as a single transaction or as a series of separate transactions, each of which must be separately tested for "tax avoidance." Under the latter approach, by separately examining each element of an integrated transaction, the Internal Revenue Service could effectively require taxpayers to choose the least tax-efficient means of achieving a given business objective.[11]

In a similar vein, it is unclear whether the tax avoidance transaction definition is intended to apply, and if so how it would be applied, to tax-favored disposition techniques, such as the redemption transactions that were the target of the 1997 amendments to Section 1059 of the Code. In many such cases, the decision to dispose of the underlying business is motivated almost entirely by non-tax business reasons, whereas the choice of a particular disposition structure may be principally tax-driven. It is also difficult to see how the comparison of pre-tax profit and net tax benefits would be applied to such a transaction.

Because of its inherent uncertainties and dependence upon subjective administrative and judicial determinations, the "tax avoidance transaction" definition as a practical matter would likely boil down to an "I know it when I see it" determination, which is by its very nature in the eyes of the beholder. As a result, the Treasury Proposals would carry a substantial risk of being overinclusive or underinclusive in their actual application, making their practical effect extremely hard to predict. Because planning to minimize taxes is such an integral part of business transactions, transactions that most people would not think of as "tax shelters" could be subject to attack. The possibility of such a result could deter risk-averse taxpayers from entering into perfectly appropriate, economically motivated but tax advantageous transactions.

Denial of tax benefits in the case of tax avoidance transactions.

The Treasury Proposals would provide for the disallowance of any deduction, credit, exclusion or other allowance obtained in a tax avoidance transaction. For the reasons discussed above, we believe that it is inappropriate for substantive tax liability to be determined based upon inherently vague definitions of tax avoidance transactions rather than specific statutory rules. In addition to our objections, discussed above, to the definition of a "tax avoidance transaction" in the Treasury Proposals, we believe that this provision would provide the Internal Revenue Service and ultimately the courts with overly broad discretion to determine taxpayers' tax liabilities. The original Administration Proposals would have given the Secretary authority to disallow tax benefits obtained in tax avoidance transactions. Although the White Paper proposes to modify the Administration Proposals by providing for a self-operative disallowance provision, the Internal Revenue Service would still as a practical matter have discretion as to whether to seek to apply the provision. The White Paper's modification is likely merely to shift the ultimate discretionary authority inherent in the disallowance provision from the administrative level to the judicial level. Once a transaction is classified as a tax avoidance transaction, it appears that all associated deductions, credits, exclusions, or other allowances otherwise available from the transaction, as opposed to only those benefits that are viewed as somehow "inappropriate" or the net tax savings otherwise resulting from a transaction, are subject to potential disallowance. In the context of a multi-step transaction, this puts further pressure on appropriately defining the scope of the "transaction" that is determined to be a tax avoidance transaction. The determination of the taxpayer's tax liability thus appears to become completely a matter of administrative and/or judicial discretion.

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[11] H.R. 2255, by providing that each transaction which is part of a series of related transactions and each step in a multi-step transaction must be tested both individually and on an overall basis, appears to impose a particularly harsh standard in this regard.

Disclosure requirements.

The Treasury Proposals would require disclosure of potential corporate tax shelters, both within 30 days after completion of the transaction and on the taxpayer's return. The White Paper proposes that the disclosure requirement should be triggered by the presence of certain "filters," such as book/tax differences, rescission, unwind, or insurance arrangements related to tax benefits, confidentiality agreements, and contingent fees payable to advisers, that are commonly associated with corporate tax shelters.

As long as the criteria for determining when transactions must be disclosed are objective and reasonably well-defined, as opposed to being based upon falling within the inherently vague definition of "tax avoidance transaction," we are in favor of these disclosure requirements. We believe that the proposed disclosure requirements would serve two useful functions. First, in the case of taxpayers that are not routinely audited, disclosure would reduce their ability to successfully play the "audit lottery" and thereby receive unwarranted tax benefits simply because the transaction is never detected. Second, requiring prompt disclosure will alert the Internal Revenue Service to potentially abusive transactions and enable it to respond more promptly through legislative proposals or changes in regulations. In this regard, the enhanced disclosure requirements greatly diminish the need for the Treasury Proposals' provisions that would disallow tax benefits based upon characterization of a transaction as a tax avoidance transaction without regard to generally applicable principles of substantive tax law. It is important, however, that the class of transactions subject to the disclosure requirement be reasonably narrow in order to ensure that the disclosure requirement is limited to transactions that are likely to have a potential for tax avoidance. Otherwise, the Internal Revenue Service will be flooded with disclosure forms regarding transactions with no real abuse potential, and the purpose of the disclosure requirements will be largely defeated.

The Treasury Proposals would also require disclosure of any transaction that a taxpayer reports in a manner different from its form. Although such transactions potentially involve some form of tax arbitrage, abusive tax shelters almost universally involve taxpayers reporting transactions in accordance with their form in a manner that is inconsistent with their substance rather than vice versa. We therefore question whether this additional disclosure requirement serves any real purpose. Nonetheless, it is possible that the Treasury Department is concerned that transactions which are reported differently from their form may involve potential for abuse, particularly in cross-border situations where taxpayers attempt to take advantage of different characterizations of the same transaction by different jurisdictions. Accordingly, in cases in which the form of the transaction is unambiguous, we do not object to this proposal.

Modifications to substantial understatement penalty for corporate tax shelters.

The Treasury Proposals would redefine corporate tax shelters for purposes of the substantial understatement penalty. A "corporate tax shelter" would be defined as "any entity, plan, or arrangement (to be determined based on all facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction." Unless the taxpayer complies with the disclosure requirements, the applicable penalty would be doubled from 20 percent to 40 percent, with an additional fixed amount penalty for failure to disclose, and the "reasonable cause" exception would be unavailable. In the case of a tax shelter where there is disclosure, the penalty would remain at 20 percent and the reasonable cause exception would be available, but only if the taxpayer had a reasonable belief that it had a "strong" probability of success on the merits (as compared to the current "more likely than not" standard applicable to tax shelters). Although the White Paper is not clear in this regard, we assume that the 20% penalty and reasonable cause exception would apply in the case of a tax shelter for which disclosure was not required.

We are in favor of increasing the penalty provided that the substantive tax rules are reasonably well-defined and the increased penalty can be avoided by complying with objectively defined disclosure requirements.[12] An increased penalty would serve as a more effective deterrent to taxpayers that engage in overly aggressive transactions in the belief that they may not be audited and that, even if they are audited, they will not be substantially worse off if their claimed benefits are disallowed than they would have been if the benefits had never been claimed, particu-

[12] In this regard, we object to the approach of H.R. 2255, which would impose the increased penalty with respect to any disallowed "noneconomic tax attribute" which is not disclosed, rather than tying the increased penalty to a disclosure requirement based on an objective standard.

larly in view of taxpayers' expectations that they will be able to negotiate a settlement during the course of an audit.

Our concerns with the proposed penalty provision stem principally from our concerns, discussed above, about the broad substantive discretion given the Internal Revenue Service and the courts to disallow tax benefits associated with tax avoidance transactions. The proposed tax shelter definition on balance is a reasonable one, and its inherent ambiguities are much less troubling, to the extent that the definition applies only for penalty purposes as opposed to serving as a basis for making determinations of underlying tax liability and as long as the stricter penalties can be avoided by taxpayers that comply with clearly defined disclosure requirements. In fact, the proposed definition represents an improvement over the current definition of "tax shelter" in Section 6662(d), which focuses on a "significant purpose" to avoid or evade Federal income tax. The current definition thus potentially encompasses transactions that are motivated primarily by non-tax economic considerations but also involve a significant tax planning—and hence tax avoidance—purpose.

As long as the disclosure requirements are triggered by bright-line standards that are easily complied with, rather than being triggered by the Treasury Proposals' broad definition of "tax avoidance transaction," we believe that eliminating the reasonable cause exception where the taxpayer fails to comply with those requirements is an appropriate mechanism for encouraging disclosure.[13] We believe, however, that the reasonable cause exception, which already is very narrow in the case of corporate tax shelters, should be retained in its current form in cases where the disclosure requirements are met. The proposed "strong probability of success" test would impose a virtually insurmountable bar to avoiding the penalty. Under current law, Treas. Reg. § 1.6664–4(e) provides that tax shelter items of corporations satisfy the reasonable cause exception only if the taxpayer's position is supported by substantial authority and the taxpayer reasonably believed that it was more likely than not to prevail; even then, a further inquiry into more subjective criteria relating to business purpose and other factors is required. It is hard to see how preservation of this narrow exception, which imposes a high standard on taxpayers and protects only those acting in good faith, would hinder unduly the Internal Revenue Service's attempt to combat tax abuse. Moreover, if substantial authority exists to support a position taken by a taxpayer and the taxpayer has received a "more likely than not" opinion from a reputable adviser who is fully apprised of the relevant facts, it is difficult to perceive how that position could be characterized as sufficiently abusive to merit a penalty, regardless of the relative magnitude of tax benefits as compared to pre-tax profits.

Taxation of income from corporate tax shelters involving tax-indifferent parties.

The Treasury Proposals would also impose tax on income realized by "tax indifferent parties" in connection with corporate tax shelters. The intent is to prevent the shifting of taxable income to foreign persons, Native American tribal organizations, tax-exempt organizations, and domestic corporations with expiring loss or credit carryovers. The income earned by the tax-indifferent party would be subject to tax, although the incidence of the tax would depend upon the nature of the tax-indifferent party. In the case of tax-exempt organizations, domestic corporations, and foreign persons not entitled to treaty protection, the tax would be imposed directly on the tax-indifferent party. In the case of Native American tribal organizations and foreign persons entitled to treaty benefits, on the other hand, the tax would be collected only from other participants who are not exempt from tax.

We do not believe that this provision is appropriate. For the most part, tax-indifferent parties to tax shelter-type arrangements do not realize benefits that are sufficient to justify changing the taxing regime applicable to them. Indeed, in many cases, the tax-indifferent party may not have sufficient information to assess the tax benefits available to the corporate taxpayer and thus to determine whether the proposed tax shelter provision would potentially be applicable. If a transaction involves an inappropriate shifting of income from a taxable corporation to a tax-indifferent party, the proper solution would be a reallocation of income to the taxable party. In proposing to collect tax on income realized by treaty-eligible foreign persons and Native American tribal organizations from the taxable corporate participants, the Treasury Department appears to recognize the merits of this approach in at least limited contexts, although the proposal is unclear as to which corporate participants are subject to tax.

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[13] Again, we believe that H.R. 2255 goes too far by eliminating the reasonable cause exception even where there is disclosure.

Regardless of the incidence of the tax, the proposed provision could result in substantial overkill. Although the White Paper would narrow the provision in the original Administration Proposals by applying the provision only to tax-indifferent parties that are "trading on their tax exemption," it appears that all the income earned by such a tax-indifferent party, not just income that is artificially shifted away from the corporate taxpayer through implementation of an abusive tax shelter, would be subject to tax. For example, where a tax-indifferent party provides funds as part of a transaction, it appears that all of its income from the transaction—including the normal rate of return on its investment—would be subject to tax. There is no justification for effectively changing the basis for taxation of this type of income earned by a tax-indifferent party on account of tax benefits realized by an unrelated corporate tax shelter participant, even if the tax is imposed on the taxable corporate participant.

Finally, we believe that the proposed provision's definition of a "domestic corporation with expiring loss or credit carryovers" that would be treated as a tax-indifferent party is overbroad. Loss and credit carryforwards that are more than three years old would generally be treated as expiring. Aside from the fact that such carryforwards may not be in serious danger of expiring, it is not clear from the General Explanation that application of the provision is dependent upon the carryforwards being available and sufficient to offset the income from the transaction in question.

Imposition of excise tax on certain fees.

The Treasury Proposals would impose a 25 percent excise tax on fees received by promoters and advisers in connection with corporate tax shelters. The White Paper proposes to delete a provision in the original Administration Proposals that would have made the fees non-deductible to the corporate tax shelter participant.

Aside from our general objections to the proposed definition of tax avoidance transaction, we believe that imposing an excise tax on the recipients of fees is inappropriate. The provision appears broad enough to apply to underwriting and other fees incurred in connection with a tax avoidance transaction, even if the particular services involved bear only a tangential relationship to the tax avoidance purpose and would have been incurred even without regard thereto. For example, a financing transaction with an improper tax avoidance purpose could involve underwriting fees no greater than, and for services largely no different from, those that would have been incurred in a less tax-efficient alternative transaction.

Moreover, promoters typically are rendering a service by presenting ideas, the evaluation of which is the responsibility of taxpayers and their advisers. It is hard to see why there should be a special tax regime applicable to these service providers.

Even if it were appropriate to impose special penalties on promoters, there is no justification for imposing an excise tax on a taxpayer's outside counsel or other tax adviser, who typically is in the position of trying to give an unbiased assessment of a proposed transaction and is not receiving a contingent fee. The risk of being subject to an excise tax has the potential to adversely affect an adviser's ability to give objective tax advice. The White Paper states that the penalty would not apply to a tax professional that advises a client that a transaction is not supportable or cautions the client not to proceed with the transaction. It is completely inappropriate for the Treasury Department to use the threat of a tax penalty on the adviser to influence the advice that the adviser gives to his or her clients. It is hard to see how the goal of sound administration of the tax system is advanced if advisers can only avoid penalties by refusing to provide proper and objective tax advice to their clients.

Imposing an excise tax on fee recipients also would present potentially insurmountable procedural problems, because the imposition of the tax is dependent upon the outcome of the determination of the corporate taxpayer's liability. Not permitting the fee recipient to contest and if necessary to litigate the underlying tax liability would be a denial of due process. Conversely, allowing the fee recipient to participate in proceedings against the corporate taxpayer would be unfair to the taxpayer and potentially would be a significant impediment to settlement of disputes. Although the White Paper appears to acknowledge this concern by stating that "appropriate due process procedures" would be provided, it is unclear how this could be effected.

Effective dates.

Under the Treasury Proposals, all the provisions discussed above would be effective on the date of first Committee action. Even if these provisions were appropriate as a general matter (which we believe they are not), it is indisputable that they represent a major change in current law and require substantial refinement. Under

those circumstances, we see absolutely no justification for a pre-enactment effective date.

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If you have any questions regarding the foregoing, please feel free to contact the undersigned at (212) 837–6315.

RESPECTFULLY SUBMITTED,

ANDREW H. BRAITERMAN
CHAIR

cc:Lindy L. Paull
Mark Prater
Timothy L. Hanford
John Buckley
Russ Sullivan

COMMITTEE ON TAXATION OF BUSINESS ENTITIES

ANDREW H. BRAITERMAN, CHAIR [14]

LOUIS H. TUCHMAN, VICE-CHAIR [15]

MARY B. FLAHERTY, SECRETARY

Statement of the Massachusetts Mutual Life Insurance Company, Springfield, Massachusetts

Massachusetts Mutual Life Insurance Company is the eleventh largest life insurance company in the United States, doing business throughout the nation. The Company offers life and disability insurance, deferred and immediate annuities, and pension employee benefits. Through its affiliates, Massachusetts Mutual offers mutual funds and investment services. The Company serves more than two million policyholders nationwide and, with its affiliates, has more than $175 billion in assets under management. Massachusetts Mutual is very concerned about efforts to categorize business life insurance as a corporate tax shelter. This sweeping generalization ignores the legitimate uses of business life insurance and the fact that Congress has already eliminated the potential for businesses to abuse the tax benefits associated with cash value life insurance.

In its revenue proposals for the fiscal year 2000 budget, the Administration identified cash value life insurance as a tax shelter that provides unjustifiable benefits to business policyholders. With recent testimony before this Committee, the staff of the Joint Committee on Taxation repeated the charge that business life insurance is just another corporate tax shelter. In support of this claim, Joint Committee staff cited the recent Winn-Dixie decision which denied an interest deduction for large-scale borrowing of policy cash values. However, there was no mention of the fact that this case involved transactions that are no longer viable under the Internal Revenue Code.

A tax shelter has been defined to exclude any "tax benefit clearly contemplated by the applicable provision" of current tax law. Over the past few years, Congress has repeatedly examined the tax treatment of business life insurance. The current rules are the product of this extensive review.

Congress weighed the tax benefits for business life insurance when it passed amendments to Section 264 of the Internal Revenue Code. Congress eliminated the use of life insurance for tax arbitrage. There are clear-cut and effective rules that now limit the ability of a business to deduct interest on debt when it holds cash value life insurance. Following amendments enacted in 1996, federal law allows a business to take an interest deduction for loans against only those insurance policies covering the life of either a 20% owner of the business or another key person. No more than 20 individuals may qualify as key persons and a business can deduct interest on no more than $50,000 of policy debt per insured life. Policies issued before June 21, 1986 are grandfathered from this rule.

Two years ago, Congress examined the tax treatment of general debt where a business also happened to hold cash value life insurance. Based on this review, it created a tax penalty for businesses that hold life insurance on their debtors, customers or any insureds other than their employees, officers, directors or 20% own-

ers. Last year, as part of its fiscal year 1999 budget, the Administration proposed extending the penalty to all business life insurance policies other than those covering 20% owners. Congress re-examined the treatment of unrelated business debt and rejected the Administration's proposal last year. Earlier this year, the Administration submitted the same proposal, with no better tax policy justification than it has offered in the past. However, this year, the Administration sought to cloak its proposal as an attempt to eliminate a tax shelter.

Further changes in tax treatment would make cash value life insurance prohibitively expensive for all businesses. Business life insurance serves many legitimate, non-tax purposes. Life insurance provides a means for businesses to survive the death of an owner, offering immediate liquidity for day-to-day maintenance of the business or the funds to purchase the decedent's interest from heirs who are unwilling or incapable of continuing the business.

Businesses purchase life insurance to meet other needs in addition to funding business buy-outs. A business must protect itself from the economic drain and instability caused by the loss of any major asset. The talents of its key personnel sustain a business as a viable force in the economy. Life insurance provides businesses with the means to protect the workplace by replacing revenues lost on the death of a key person and by offsetting the costs of finding and training a suitable successor. Businesses use life insurance to provide survivor and post-retirement benefits to their employees, officers and directors. As part of a supplemental compensation package, these benefits help attract and retain talented and loyal personnel, the very individuals who are crucial to the ongoing success of any business. Treating cash value life insurance as a tax shelter would penalize a business that tried to take reasonable measures to protect itself or to provide benefits for its employees.

The legitimate needs for workplace protection insurance have not altered in the past three years. Nor will the business need for life insurance simply disappear if business life insurance is treated as a tax shelter. However, the resulting effect for businesses will be punitive. Term insurance does not provide businesses with a reasonable alternative to cash value insurance. While often appropriate for temporary arrangements, term insurance is both costly and unsuitable for long-range needs. Application of the tax shelter stigma to cash value life insurance is an exceedingly harsh punishment to impose on a business for taking prudent financial measures to protect its valuable human assets or to provide benefits for its employees and retirees.

Congress has repeatedly examined the tax treatment of business owned life insurance. Amendments it has passed in the last several years have effectively curtailed the use of life insurance for tax arbitrage. There is no reason to change the rules yet again. There is no justification for penalizing businesses that purchase cash value life insurance to safeguard their own well being or to provide benefits for their workforce. Businesses use life insurance for legitimate purposes. Like any other taxpayer, a business also needs some stability in the tax law in order to make long-term plans for its own financial welfare and that of its employees. Congress revisit the tax treatment of business life insurance, for the fourth time in four years, with the express purpose of removing the carefully crafted rules set in the 1996 and 1997 tax acts.

Statement of Stephen L. Millman, and Steven C. Salch, Fulbright & Jaworski L.L.P., Houston, Texas

Chairman Archer and Members of the Committee:

Fulbright & Jaworski L.L.P. is a law firm with offices in three States, the District of Columbia, and two foreign countries. Our Firm is has been in existence for over 80 years, and has engaged in federal tax practice for over 70 years. Our tax practice extends to all phases of state and federal taxation. We are involved with commercial and financial transactional planning, documentation, and consummation, and defense of taxpayers on examination, during administrative appeals, and in litigation. Our clients include individuals, corporations, partnerships, trusts, estates, and financial institutions, both domestic and foreign. We do not engage in the sale of "tax

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[14] Member of the Committee principally responsible for the drafting of the letter.

[15] Member of the Subcommittee that prepared the letter. Sydney E. Unger, the former chair of the Committee, also participated in the preparation of this letter. The assistance of Mary B. Flaherty is gratefully acknowledged.

products." However, we have been exposed to those "products" in the course of representation of clients to whom "products" have been offered.

We appreciate the opportunity to offer this written statement for consideration by the Committee members and inclusion in the record of this hearing. We have followed the evolution of the study of corporate tax shelters from the debate concerning the enactment of the confidential corporate tax shelter registration provisions, the preservation of those provisions in enactment of the federally-authorized tax practitioner privilege provisions, the Study done by the Staff of the Joint Committee on Taxation [1], and the Treasury Department White Paper [2] and Penalty Report.[3]

Members of our firm have participated in various capacities in the activity of the Section of Taxation of the American Bar Association concerning tax shelters since the early 1980's. We have defended individuals and entities who have invested in tax shelters promoted by others. We also have defended individuals and entities whose legitimate tax planning has been challenged by the Internal Revenue Service upon examination. Those experiences, and the sense of the delicate balance that must be maintained to preserve both the integrity of the tax system and the perception of taxpayers of the fairness of the tax system and tax administration, are the foundation for the comments and suggestions in this statement.

We commend both the Joint Committee Staff and the Treasury Staff for the prodigious effort and thoughtful manner in which they have approached the issue of corporate tax shelters. Their reports provide a solid basis from which to study that problem. We also commend Chairman Archer for his recognition that any action, legislative or administrative, intended to restrain the proliferation of "abusive corporate tax shelters," must be carefully and thoughtfully constructed and narrowly focused to assure that legitimate business transactions are not chilled or opened to challenge.

We believe the marketing of "tax product" including "corporate tax shelters," and particularly "products" marketed under confidentiality agreements demanded by, and running in favor of, the promoter of such "products," has become a substantial problem. There are many reasons for this phenomenon. They include: the inefficiency and anticompetitive character of the federal corporation income tax; the pressure the financial markets exert on domestic businesses to constantly grow cash flow and profits; the apparent need of some tax practitioners to develop and market "products" to non-clients, as well as clients, in order to generate additional revenue for themselves, and a penalty system that penalizes disclosure, rather than rewarding it.

It is important to approach these issues remembering that a taxpayer has no duty to pay the maximum possible amount of tax that might be owed. Rather, a taxpayer is free to arrange its affairs so that it pays the least amount of tax on the profits it derives, consistent with the tax laws. Indeed, the tax law affords the taxpayer many options as to form and timing of recognition of income or losses. Thus, the first and most difficult task in approaching the problems posed by "abusive corporate tax shelters" is that of defining "abusive corporate tax shelter."

We are concerned that the presently proposed definitions of "corporate tax shelter" are too broad. For example, two generally-accepted types of transactions appear to fall into the definitions currently under study. One is preferred stock which has a dividend rate that is reset periodically and for which there is assurance to a corporate holder that at each reset, someone will buy out its investment, at par, if it so desires. Billions of dollars of this "remarketed preferred stock" are sold annually, and it is a vital tool for corporate financial planning. But the combination of pre-tax yield and a dividend received deduction is what makes the shares marketable. The pre-tax yield, per se, is inadequate to attract buyers. The issues are marketed by investment banks or underwriters whose fees are typically stated as a percentage of the aggregate par value of, or dollars paid for, the preferred shares sold by the issuer. Presumably, some mathematician could translate those transaction-size percentage fees to a percentage of dividends payable (since the stated dividend rate is a percentage of the par value of the preferred). The original impetuses for these transactions were proposals by investment bankers, backed by tax opinions.

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[1] Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the IRS Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters) JCS–3–99 (July 7, 1999) (sometimes hereinafter referred to as the "Study" or the "JCT Staff Study").

[2] The Problem of Corporate Tax Shelters—Discussion, Analysis and Legislative Proposals (July 1, 1999) (sometimes hereinafter referred to as the "White Paper" or the "Treasury White Paper").

[3] Report to Congress on Penalty and Interest Provisions of the Internal Revenue Code (October 25, 1999) (sometimes hereinafter referred to as the "Report" or the "Treasury Report").

Leveraged leasing shares most of the same characteristics. The tax investor's pre-tax profit is well below standard interest rates—it is the tax benefits that make the transaction marketable on the economic terms employed. Most of the lessees would not be able to use the depreciation if they did no leasing; the lessor can, and intermediaries market the transactions and take a fee based on the transaction size that could, mathematically, be translated into a percentage of depreciation deductions available to the lessor. As the JCT Staff Study clearly points out, leveraged leasing has been distinguished from other transactions by a special set of judicially-crafted criteria to determine ownership, and tax treatment of the parties.[4] Leveraged equipment leasing is a vital economic tool to many industries, allowing manufacturers to increase sales of products by lowering the cost of ownership to end users.

Both of these techniques have been blessed by the courts and the IRS. However, since they would appear to be "tax shelters" under most of the presently-proposed definitions, we are concerned that the proposed legislation might chill these financial planning tools and unnecessarily inhibit evolution of future tools that are similar in effect. Thus, we urge the Committee to at least except leasing transactions subject to the special rules discussed in the JCT Staff Study from the ambit of any broad-based definition of "tax shelter."

We believe many of the "products" being marketed today would disappear from the marketplace if the Treasury Department would promulgate implementing regulations for the confidential arrangement tax shelter registration provisions of section 6111(d) of the Internal Revenue Code of 1986, as amended. If "products" are required to be registered with the Internal Revenue Service and taxpayers utilizing products are obligated to disclose they are utilizing products, identified by a tax shelter registration number assigned by the Internal Revenue Service, many of the objectives of the several proposals of the Joint Committee Staff and the Treasury Department could be accomplished quickly and effectively, without the necessity of additional litigation.

Registration and identification would eliminate any impact of confidentiality undertakings on the tax system. Registration, promoter recordkeeping, and taxpayer reporting should also make it relatively easy for the Internal Revenue Service to determine the taxpayers who have employed a particular product and protect the statute of limitations while examining and evaluating that product. To the extent such "products," like vampires, vaporize when exposed to the light of day, registration and identification would have a positive impact on tax administration.

We do not know why the Treasury Department has failed to promulgate the regulations necessary to effectuate and activate section 6111(d). However, to the extent the delay of approximately two years is attributable to Treasury's inability to develop a definition of "tax shelter," it should alert the Congress of the dangers and difficulties inherent in endeavoring to develop a legislative definition of "tax shelter" that does not chill bona fide business transactions that possess some features that are common with the "products" marketed under confidentiality covenants running in favor of the promoter.

On balance, we do not believe major, new legislation of the type suggested by the Joint Committee Staff and the Treasury Department is necessary or desirable to deal with the "corporate tax shelter" problem. To the extent that implementation of the registration provisions does not materially inhibit the mass marketing of abusive "products," the Internal Revenue Service and the courts have employed existing legal tools to impose tax liability and penalty liability on corporations employing "products" in an effort to reduce their federal income tax liability.

The JCT Staff Study enumerates the judicial doctrines, including sham transaction, step transaction, substance over form, economic substance, and business purpose that have been a part of the fabric of tax law for more than 60 years in some cases. They have survived and thrived, without legislative definition or delineation, and shown themselves to be sufficiently flexible to permit ready adaptation to address the particular abusive transaction currently in vogue. We are concerned that any effort to define and incorporate those judicial doctrines into the Internal Revenue Code would destroy their flexibility and inhibit their future utility. Thus, while we encourage the Committee, the Congress, and the Treasury Department to reaffirm the continuing viability of these doctrines and their application to transactions, we respectfully urge that you refrain from trying to define them by legislation.

Our concern that legislating these doctrines would be counterproductive is premised in part on our perception of the effect of excessive delineation of objective standards or criteria in the Internal Revenue Code. When Congress enacts a tax statute with extreme specificity, some taxpayers and tax professionals are encouraged to believe that any variant that is completely within a beneficial provision is

[4] See, e.g., Frank Lyon v. U.S., 435 U.S. 561 (1978).

permitted, without regard to whether it has substance or business purpose, or conversely, that any transaction that does not fall entirely within a statutory prohibition's explicit terms is permitted. Neither of those views is completely accurate, but they are the seeds of much of the "product" presently being marketed to taxpayers. Thus, we urge the Committee to permit the judicially-developed doctrines to remain a part of the common law, rather than endeavoring to explicitly define and incorporate them into the Internal Revenue Code of 1986.

The successes of the IRS in the courts, subsequent to the issuance of the JCT Staff study and the Treasury White Paper, in employing the judicial doctrines to address transactions clearly establishes the viability of the doctrines in their present form and their utility to the IRS to cover a broad range of transactions from foreign tax credit capture transactions[5] and foreign captive insurance[6] to corporate owned life insurance.[7] These recent successes, including the imposition of penalties in the United Parcel Service and Compaq Computer cases, demonstrate that the present system does work and is effective. To be sure, it takes time and effort. However, that expenditure of time and effort helps assure that the IRS is seeking the right answer, rather than crying "tax shelter" and pursuing a properly motivated transaction that has been implemented in a way that minimizes tax liability. Also, that time and effort was more than justified by the amounts in issue and the impact those decisions are already having in the "product" marketplace.

As the JCT Staff Study and the Treasury White Paper observe, "products" are frequently marketed under contracts in which the promoter endeavors to limit liability to the customer in the event the product is unsuccessful and seeks compensation from the customer if the customer breaches confidentiality or third parties proceed against the promoter. Now that the IRS has successfully asserted penalties in litigation,[8] larger customers are refusing to provide promoters with those limitation and indemnity agreements and are demanding stronger warranties from the promoters. If this trend continues, over time the more tenuous "products" will either be driven from the marketplace or move to smaller customers with less bargaining power or sophistication. In the latter event, disclosure will become more important to tax administration.

The JCT Staff Study and the Treasury White Paper adopt the approach that disclosure of tax return positions is desirable for tax administration but should only provide mitigation against an enhanced penalty, rather than protection against imposition of an accuracy-related or substantial authority penalty in tax shelters. The premise for disclosure is to assist the IRS in identifying shelter products and the taxpayers who have employed them. Both the Study and the White Paper comment that the IRS has difficulty identifying tax shelter transactions in corporate audits. If that is true, then disclosure seemingly would help the IRS. However, to induce a taxpayer to disclose a position that potentially would not be located by the IRS in the absence of disclosure requires something more than the difference between a 20% penalty and a 40% penalty.

The Study and the White Paper do not fully appreciate the significance of *any* penalty to a corporate tax professional. Imposition of a penalty based on action or inaction is frequently grounds for immediate termination and loss of employee benefits, such as unexercised stock options. Thus, to motivate a corporate employee in such a position to disclose, disclosure must afford per se exemption from an accuracy-related or substantial authority penalty as long as the return position meets a standard that is slightly lower than the threshold standard for imposition of a penalty without disclosure. In other words, disclosure and a lower standard, provide sufficient meaningful reward to induce disclosure. If, as under present law, disclosure is effective to provide protection against a penalty only if the return position satisfies the standard necessary to avoid imposition of a penalty on an undisclosed transaction, disclosure not likely if imposition of *any* penalty is a career-ending event. The corporate employee is going to play the audit lottery, rather than disclose and risk a penalty—whether at a 1% or 40% rate.

We also recognize the role that "tax opinions" are playing in the corporate tax shelter product marketing process. The only difference we discern from that role and the role similar "opinions" played in the individual tax shelter craze of the late 1970's and early 1980's is the number of taxpayers to whom any single "opinion"

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[5] *Compaq ComputerCorporation v. Commissioner,* 113 T.C. No 17 (September 21, 1999); *IES Industries, Inc. v. U.S.*, No. 97–206 (DCND IA, September 22, 1999)

[6] *United Parcel Service of America v. Commissioner,* T.C. Memo 1999–26528 (August 9, 1999).

[7] *Winn-Dixie Stores, Inc. v. Commissioner,* 113 T.C. No. 21 (October 19, 1999).

[8] See, United Parcel Service of North America, and Compaq Computer Corporation, supra.

is presented.[9] From a professional perspective the obligations of an attorney to his or her client should not change based on the number of clients to whom the attorney's opinion is ultimately addressed. Indeed, in our experience, many law firms have applied the thrust of ABA Formal Opinion 346 (Revised)[10] in all their tax law opinions to their clients—not merely those that fit the definition of "tax shelter" set forth in that Opinion. However, we are aware that not all law firms or lawyers share our views or adhere to this principle as a "best practice." Thus, we support modification of Circular 230[11] to clarify that the due diligence precepts and preclusion of hypothetical fact predicate principles of ABA Formal Opinion 346 (Revised)[12] extend to all tax opinions rendered by those entitled to practice before the IRS.

Since the Agency Practice Act of 1965[13] *entitles* every individual licensed and in good standing under local law as an attorney or a certified public accountant to practice before the IRS, the suggested changes to Circular 230, like the 1986 amendment adopting section 10.33, can be adopted as a principle of reputable conduct and due diligence by every lawyer and CPA, without regard to whether that lawyer or CPA actually practices before the IRS or the "opinion" itself is "practice before the IRS," within the meaning of section 10.2 of Circular 230, and without regard to whether the "opinion" is one which the CPA is legally authorized to issue under the law of the State which has issued his or her CPA license.[14]

At present a practitioner can be suspended from practice before the IRS by reason of a felony conviction for robbery. That does not, however, require a finding that the act of robbery is "practice before the IRS," within the meaning of Circular 230. Under the same rationale, an individual can be suspended from practice before the IRS by reason of issuance of an improper "tax shelter opinion" without necessity of a finding that the rendition of the opinion is "practice before the IRS."

In certain respects, Circular 230 preempts State law.[15] We believe preservation of State law and judicial remedies are important when professional conduct is the issue in order to protect the rights of taxpayers and the shareholders of corporate taxpayers. Their right to pursue State law malpractice or derivative actions against promoters of "abusive tax shelters" who employ inappropriate "tax opinions" should not be preempted. Indeed, since the ABA Model Rules of Professional Conduct contain specific limitations on the ability of lawyers to ethically seek advance agreements limiting malpractice liability to their client, yet the AICPA Code of Professional Responsibility does not, it appears proper to amend Circular 230 to provide that it is disreputable for an individual eligible to practice before the IRS to seek to limit his or her malpractice liability to any client as to any matter that relates to federal taxation in advance of either performing the service or the assertion by the client of the claim to which the attempted limitation would be applicable. To the extent that a lawyer, CPA, or enrolled agent presently is promoting "products" and employing such limitations, this modification of Circular 230 would curtail that practice.

Since our role generally is that of advising our clients regarding "products" promoted by others, including advising our clients not to participate, we appreciate the acknowledgement by the Treasury Department in the Treasury Report that its proposal to impose an excise tax on the fees charged by professionals advising their clients regarding "tax shelters" would not apply to fees charged by a professional advising a client not to participate in a "tax shelter." However, we are concerned that an excise tax liability dependent on the tenor of the legal advice rendered could

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[9] We understand some vendors of "product" deliberately limit the number of taxpayers to whom a particular "product" will be offered.

[10] ABA Standing Committee on Professional Responsibility (January 29, 1982).

[11] The Treasury Department Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service, codified at 31 CFR Subtitle A, Part 10, and reprinted as Treasury Department Circular 230 (hereinafter referred to as "Circular 230").

[12] "The lawyer should relate the law to the actual facts to the extent the facts are ascertainable. The lawyer should not issue an opinion which a discusses purely hypothetical facts." ABA Formal Opinion 346 (Revised) (January 29, 1982).

[13] Codified at 5 USC § 301.

[14] Circular 230, section 10.32, provides, "Nothing in the regulations in this part shall be construed as authorizing persons not members of the bar to practice law." Note in this regard that the Notice of Final Rulemaking that announced promulgation of section 10.33 specifically noted that the promulgation of section 10.33 did not represent a conclusion that the issuance of a "legal opinion" by an authorized practitioner other than an attorney engaged in the private practice of law was permissible.

[15] *Sperry v. Florida*, 373 U.S. 379 (1953). See also, *Salch, Inter-professional Practice Issues: A Debate and Discussion, The "Practice of Tax," 50 Major Tax Plan*. 5–500, 5–506 (Matthew Bender 1998).

present a conflict of interest between the advisor and the client that would necessitate disclosure and waiver of the conflict by the client.

We appreciate the opportunity to submit these comments. The principal drafters of these comments were Steven C. Salch (713–651–5433) in our Houston office and Stephen L. Millman (212–318–3039) in our New York office. Please contact either of them if you or your staffs have questions about any of our comments.

Statement of Washington Counsel, P.C., on behalf of Tax Fairness Coalition

COMMENTS ON CORPORATE TAX SHELTER RECOMMENDATIONS MADE BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION IN ITS PENALTY AND INTEREST STUDY [1]

This paper sets forth comments on the "corporate tax shelter" and certain other penalty recommendations made by the staff of the Joint Committee on Taxation ("JCT" or "Joint Committee") in its penalty and interest study that was recently submitted to the House Committee on Ways and Means and the Senate Committee on Finance as required by the Internal Revenue Service Restructuring and Reform Act of 1998 (the "JCT Study").[2]

I. INTRODUCTION

We commend the JCT for its rejection of proposals made by the Administration [3] and others [4] to (i) give the Executive Branch and IRS agents unfettered discretion to rewrite substantive tax rules or (ii) impose explicit tax increases on other parties that participate in, and benefit from, transactions covered by their recommendations (*e.g.*, levies on tax-indifferent parties, disallowed deductions for ordinary and necessary business expenses, and excise taxes on fees paid to third parties or routine indemnification arrangements). We agree that such proposals have no place in the current debate. We particularly commend their discussion regarding the importance of a "rules based" system of taxation.

According to the JCT Study, its recommendations are intended to address both current and future corporate tax shelter transactions using a balanced approach that does not interfere with legitimate tax planning activities and does not result in increased complexity or unfair penalties. We embrace this objective as a fundamental requirement of any response to corporate tax shelters. Not only does such an objective adhere to the spirit of the legislation which called for the JCT Study,[5] but it will be essential to ensure the success of any legislative changes in their practical application. As detailed below, however, we believe that the JCT's recommendations would benefit from further analysis.

The JCT Study proposals are sweeping; they would create a new and enhanced web of rules that would have a significant effect on taxpayers and tax administration. If enacted, the JCT's recommendations would fundamentally change the nature of tax compliance. We are concerned that, while thoughtful and well-intended, the JCT Study proposals could, in practice, do more harm than good. In particular, we are concerned that the JCT Study proposals would:

- have the practical effect of creating a strict liability penalty regime that would apply to legitimate tax planning and routine business transactions and would provide IRS agents with new weapons to extract inappropriate concessions from taxpayers;
- penalize tax advisors and return preparers on more than one hundred percent of their income when their advice turns out to be wrong;

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[1] Staff of the Joint Committee on Taxation, 106th Cong., 1st Sess., *Study of Present-Law Penalty and Interest Provisions As Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* JCS–3–99 (July 22, 1999).

[2] P.L. 105–206 (July 22, 1998).

[3] *See* United States Treasury Department, *General Explanations of the Administration's Revenue Proposals* (February 1999).

[4] In H.R. 2255, 106th Cong., 1st Sess. (1999), Rep. Doggett (for himself and Reps. Stark, Hinchey, Tierney, Allen, Luther, Bonior and Farr), introduced a proposal to disallow tax benefits claimed to arise from transactions without substantial economic substance (the "Doggett Bill").

[5] Section 3801 of the IRS Restructuring and Reform Act of 1998 required both the Joint Committee and the Treasury Department to make recommendations to simplify penalty or interest administration and reduce taxpayer burden.

- have the practical effect of discouraging legitimate tax planning and routine business transactions while forcing more and more taxpayers into refund litigation; and
- add another layer of mind-numbing complexity to the Internal Revenue Code.

Moreover, the Congress will find it difficult to reclaim any power that it delegates to the Executive Branch because any attempts to reverse such actions would be scored as revenue losers under current revenue estimating conventions. For these reasons, the Congress should not enact the JCT Study proposals, or other similar legislation at this time. Rather, the Congress should continue to monitor the situation and instruct the IRS and Treasury to make use of the tools already at their disposal.

This paper briefly describes the corporate tax shelter recommendations set forth in the JCT Study. The paper then outlines a general framework for addressing corporate tax shelters. Next, the paper provides specific critiques of certain of the corporate tax shelter recommendations made by the JCT. Although not addressed in detail in this paper, many of the comments made herein with respect to the recommendations set forth in the JCT Study, particularly the general framework for addressing corporate tax shelters, are equally applicable to the proposals made by the Treasury Department in its recently released white paper on corporate tax shelters (the "White Paper").[6]

II. Overview of the Joint Committee's Proposals

The JCT Study recommends an expansive definition of corporate tax shelters that covers a broad range of routine business transactions and ordinary tax planning activities (hereinafter sometimes referred to as "Covered Transactions"). It also recommends greatly expanding the scope of penalties that may be imposed on taxpayers and third parties through proposals that are extremely complex. The JCT's corporate tax shelter recommendations generally fall into three categories: (i) proposals targeted at corporations that participate in corporate tax shelters; (ii) proposals targeted at other parties involved in corporate tax shelters; and (iii) proposals relating to disclosure and registration requirements. Following is a brief overview of these proposals.[7]

A. Proposals Targeted at Corporate Taxpayers

The JCT Study recommends fundamental changes in the corporate tax shelter provisions of the Section 6662 substantial understatement penalty.[8] Under current law, Section 6662 imposes a penalty for a substantial understatement of income tax in cases involving tax shelters. For purposes of this rule, Section 6662(d)(2)(C)(iii) defines the term "tax shelter" as:

> A partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

If the understatement exceeds certain thresholds, then the taxpayer is subject to a twenty percent penalty unless the taxpayer has substantial authority for the position it is taking and reasonably believes that it is more likely than not to prevail on the merits if challenged by the IRS.[9]

The JCT Study recommends: (i) modifying the "tax shelter" definition; (ii) eliminating the requirement that an understatement be "substantial" before a penalty is imposed; (iii) creating a two-tier (i.e., forty percent/twenty percent) penalty rate; (iv) mandating imposition of the penalty unless the taxpayer prevails in court; and (v) repealing the substantial authority/reasonable cause exception unless the taxpayer satisfies certain disclosure requirements and is able to establish that it had (A) a greater than seventy-five percent certainty of prevailing in litigation and (B) a material non-tax business purpose for the transaction.

1. Modification of "Tax Shelter" Definition

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[6] Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (July 1999).

[7] As described below, a number of the proposals addressing corporate tax shelters are embedded in the JCT Study's recommendations regarding other penalty provisions.

[8] Unless otherwise indicated, all Section references are to Sections of the Internal Revenue Code of 1986, as amended (the "Code").

[9] In this regard, for reasons that will become clear, it is worth noting that the IRS has taken the position that mistakes of fact (e.g., an overlooked or misunderstood transaction or document) can *never* have substantial authority.

The JCT Study would automatically treat a transaction as a tax shelter if it is described by one or more of the following five indicators (the "Tax Shelter Indicators"):

- The reasonably expected pre-tax profits from the arrangement are insignificant relative to the reasonably expected net tax benefits.
- The arrangement involves a tax-indifferent participant, and the arrangement (a) results in taxable income materially in excess of economic income to the tax-indifferent participant, (b) permits a corporate participant to characterize items of income, gain, loss, deductions, or credits in a more favorable manner than it otherwise could without the involvement of the tax-indifferent participant, or (c) results in a non-economic increase, creation, multiplication, or shifting of basis for the benefit of the corporate participant, and results in the recognition of income or gain that is not subject to Federal income tax because the tax consequences are borne by the tax-indifferent participant.
- The reasonably expected net tax benefits from the arrangement are significant, and the arrangement involves a tax indemnity or similar agreement for the benefit of the corporate participant other than a customary indemnity agreement in an acquisition or other business transaction entered into with a principal in the transaction.
- The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is reasonably expected to create a "permanent difference" for U.S. financial reporting purposes under generally accepted accounting principles.
- The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is designed so that the corporate participant incurs little (if any) additional economic risk as a result of entering into the arrangement.

The list of Tax Shelter Indicators would not be exclusive. Accordingly, even if no Tax Shelter Indicator is present with respect to a particular transaction, the "significant purpose" test nonetheless could be met and an entity, plan or arrangement could still be a corporate tax shelter (*i.e.*, a Covered Transaction) for purposes of the penalties imposed under Section 6662.

2. Elimination of Threshold for Imposing the Penalty

Because the JCT Study recommends repeal of the requirement that the understatement be "substantial," any understatement attributable to a Covered Transaction would be subject to the penalties imposed under Section 6662.

Creation of a Two-Tier Penalty Rate

The JCT Study recommends increasing the understatement penalty rate under Section 6662 from twenty percent to forty percent for any understatement that is attributable to a Covered Transaction. If the IRS decided to challenge the claimed tax treatment of what it viewed as a Covered Transaction, the IRS would not have the discretion to waive the understatement penalty in settlement negotiations or otherwise. As a result, the taxpayer could only avoid imposition of the penalty by successfully litigating the transaction in court and (if unsuccessful on the merits) litigating over whether the transaction was a Covered Transaction and the potential application of the abatement rules described below.

a. The forty percent penalty could be completely abated (i.e., no penalty would apply) if the corporate taxpayer established that it satisfied the following abatement requirements: (i) the corporate taxpayer must have analyzed the transaction to determine whether any Tax Shelter Indicators are present; (ii) if one or more Tax Shelter Indicators exist, the corporate taxpayer must have complied with all disclosure requirements (as described below); (iii) a chief financial officer or other senior corporate official must have certified that such disclosure is true, complete and accurate; and (iv) at the time the corporate taxpayer entered into the transaction, the corporate taxpayer must have been "highly confident" that it would prevail on the merits if the tax treatment for the arrangement was challenged by the IRS.

The JCT Study prescribes two criteria for satisfying the "highly confident" standard. First, this standard would be satisfied only if a reasonable tax practitioner would believe there existed, at the time the transaction was entered into, at least a seventy-five percent likelihood that the tax treatment would be sustained on the merits based upon the facts and the law that existed at that time. In making this determination, taxpayers could not take into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled. Taxpayers could rely on third-party opinions to satisfy the "highly confident" standard, but only if such reliance is reasonable, within the meaning of Treas. Reg. § 1.6664–4(c). Second, a corporate taxpayer would not be treated as meeting the "highly confident" standard unless it can establish a material purpose

germane to its trade or business for the transaction, other than the reduction of Federal income taxes (a "Material Non-tax Business Purpose").

b. The forty percent penalty could be reduced to twenty percent for a Covered Transaction: (i) described by a Tax Shelter Indicator if the taxpayer meets the reportable transaction disclosure requirements (described below) and meets the substantial authority threshold; (ii) that is not described by a Tax Shelter Indicator if the taxpayer meets the current law more likely than not threshold (without any disclosure) or (iii) that is not described by a Tax Shelter Indicator if the taxpayer meets the substantial authority (but not the more likely than not) standard and if the taxpayer meets the generally applicable disclosure requirements of Section 6662(d)(2)(D).

c. These proposals should be viewed in light of the JCT Study's general recommendations with respect to standards for tax return positions applicable to all taxpayers (individual and corporate). In general, with respect to the twenty percent substantial understatement penalty of Section 6662, these recommendations would: (i) raise the threshold for undisclosed return positions from substantial authority to more likely than not; (ii) raise the threshold for disclosed return positions from reasonable basis to substantial authority and (iii) subject all taxpayers to a twenty percent penalty on understatements if the substantial authority standard is not satisfied, without regard to whether the matter is disclosed.

PROPOSALS TARGETED AT OTHER INVOLVED PARTIES

In addition to recommendations with respect to corporate taxpayers that participate in Covered Transactions, the JCT Study recommends certain penalties and sanctions with respect to other parties that participate in the creation, implementation or reporting of a Covered Transaction that results in an understatement penalty for a corporate participant.

1. Return Preparer Penalty

The JCT Study recommends raising the standard of conduct for income tax return preparers regarding positions on a return that result in an understatement of a taxpayer's liability. In general, the penalty would apply unless: (i) the tax return preparer reasonably believed that the more likely than not standard was satisfied (in which case no disclosure would be required under Section 6662(d)(2)(B)) or (ii) the substantial authority standard was satisfied and the position was disclosed. In this regard, the JCT Study would increase the substantial authority standard for preparers from the realistic possibility of success standard (i.e., the "one-in-three" test)[10] to a greater than forty percent likelihood of success. If the substantial authority standard is not satisfied, then the preparer would in all cases be subject to the preparer penalty (without regard to whether the item had been disclosed).

The JCT Study recommends increasing the first-tier penalty on preparers, under Section 6694(a), from $250 to the greater of $250 or fifty percent of the preparer's fee. In addition, the second-tier penalty on preparers, under Section 6694(b), would be increased from $1,000 to the greater of $1,000 or one hundred percent of the preparer's fee.[11]

It is worth noting that these changes would apply to all tax return preparers, regardless of the type of taxpayer (*i.e.*, individual or corporate) and regardless of whether any items covered by the tax return relate to corporate tax shelters.

2. Aiding and Abetting Penalty

The JCT Study recommends several modifications to the existing penalty under Section 6701 for aiding and abetting the understatement of tax liability.[12] First, the

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[10] Treas. Reg. § 1.6694–2(b)(1).

[11] As a practical matter, such penalties would almost always result in levies that exceed one hundred percent of the preparer's net after-tax income. For example, if you assume that a preparer's cost of doing business is thirty percent of gross receipts and that the preparer is subject to a combined federal and state income tax rate of forty percent, then the preparer's net after-tax income on a $10,000 fee would be $4,200. In this example, regardless of whether the fifty percent or one hundred percent penalty applies, the amount of the penalty will exceed the preparer's after-tax income. Moreover, regardless of the preparer's cost of doing business, a one hundred percent penalty rate will always exceed the preparer's after-tax income because penalties are not deductible under the Code.

[12] This penalty applies with respect to both the preparation of tax returns and the presentation of tax returns (*i.e.*, in audits and refund claims). Moreover, no actual understatement of liability is required for the penalty to apply. Rather, Section 6701 merely requires that the return preparer know (or have reason to believe) that an understatement would result from the use of the return as prepared. *See, e.g., Kuchen v. Commissioner*, 679 F. Supp. 769 (D. Ill. 1988).

amount of the penalty would be increased from $10,000 to the greater of $100,000 or one-half the fees related to the transaction received by the person penalized.[13]

Second, the scope of the penalty would be expanded to apply to any person who aids or assists in, procures, or advises with respect to the creation, implementation or reporting of a Covered Transaction that results in an understatement of tax liability of a corporate participant if: (i) the person to be penalized knew, or had reason to believe, that the Covered Transaction (or any portion thereof) could result in an understatement of tax liability of the corporate participant; (ii) the person opined, advised, represented or otherwise indicated (whether express or implied) that, with respect to the tax treatment of the Covered Transaction (or any portion thereof), the highly confident standard would be satisfied; and (iii) a reasonable tax practitioner would not have believed that, with respect to the tax treatment of the Covered Transaction (or any portion thereof), the highly confident standard would be satisfied.

The latter requirement appears to establish a standard for tax return preparers that is different than that recommended by the JCT Study for taxpayers. The difference, which is so subtle that it might be unintentional, is that a tax return preparer *would* be liable for the penalty if a reasonable tax practitioner *would not* have believed that the highly confident standard would be satisfied, whereas a taxpayer *would not* be liable for the substantial understatement penalty if a reasonable tax practitioner *would* have believed that the highly confident standard would be satisfied. Thus, a taxpayer need find only one reasonable tax practitioner to agree that it meets the standard, while a tax return preparer needs to ensure that every reasonable tax practitioner agrees that it meets the standard.

The IRS would be required to publish the names of all persons who have been penalized under this provision. In addition, such persons would be automatically referred to the IRS Director of Practice and the appropriate state licensing authority for possible disciplinary sanctions.

3. Enjoining Promoters

The JCT Study recommends modifying the authority of Federal district courts under Section 7408 to enjoin promoters of Covered Transactions or the aiding and abetting of the understatement of tax liability. Section 7408 would be amended to provide that the traditional equity factors such as irreparable injury and likelihood of success on the merits need not be considered once the government has satisfied the statutory requirements (*i.e.*, that the promoter has engaged in conduct subject to penalty under Sections 6700 or 6701 and that injunctive relief is appropriate to prevent a recurrence of such conduct).

4. Regulation of Professional Conduct of Practice

The JCT Study recommends that explicit statutory authorization for Treasury Circular 230 (relating to regulation of practice before the IRS) be provided in the Code, including authorization for the imposition of monetary sanctions not to exceed one hundred percent of the aggregate fees associated with the sanctioned conduct.[14]

In addition, the JCT Study recommends numerous modifications to Circular 230, which generally are intended to reflect the other recommendations made in the JCT Study. Perhaps most noteworthy is that the rendering of tax advice in connection with a Covered Transaction would be treated as practice before the IRS without regard to whether the advisor was a return preparer with respect to that matter. Presumably, the IRS would be entitled to access to that advice for purposes of determining whether the provisions of Circular 230 were implicated.[15]

C. Disclosure and Registration Proposals

The JCT Study includes specific proposals requiring disclosure by corporate taxpayers that participate in Covered Transactions and registration of such transactions, either by the promoter thereof or corporate taxpayers that participate in the transaction.

1. Participant Disclosure

The JCT Study would require any corporate taxpayer that participates in any transaction which is described by one or more of the Tax Shelter Indicators (a "Re-

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[13] As discussed *supra*, in footnote 11, such penalties would almost always result in levies that exceed one hundred percent of the third party's net after-tax income.

[14] Id.

[15] Compare Section 7425 (establishing a confidentiality privilege for certain taxpayer communications).

portable Transaction") to disclose its participation in such transaction within thirty days after the close of the transaction ("30-day Disclosure") and again on the taxpayer's Federal income tax return ("Tax Return Disclosure"). As indicated above, satisfaction of these disclosure requirements would be a prerequisite to partial or complete abatement of the penalties that apply to corporate taxpayers in connection with Reportable Transactions. Moreover, because the JCT Study would define a "corporate participant" as any domestic corporation with average annual gross receipts in excess of $5 million, it appears that this disclosure may be required of any corporate taxpayer that participates in the transaction, even if the taxpayer does not obtain any tax benefits from the transaction (*e.g.*, any bank that provides financing in connection with a Reportable Transaction would be required to comply with these disclosure requirements).

a. The 30-day Disclosure requirement would apply to any Reportable Transaction in which the reasonably expected net tax benefits equal or exceed $1 million. Corporate taxpayers participating in such transactions would be required to disclose: (i) the relevant facts and assumptions with respect to the transaction; (ii) the reasonably expected net tax benefits arising from the transaction; (iii) which Tax Shelter Indicators describe the transaction; (iv) a summary of the taxpayer's rationale and analysis underlying the tax treatment of the transaction, including the substantive authority relied on to support such treatment; (v) the taxpayer's Material Non-tax Business Purpose for the transaction; and (vi) the existence of any expressed or implied fee arrangement with a third party which is contingent upon or is otherwise to be determined based upon the tax consequences of the transaction. The chief financial officer or another senior corporate officer with knowledge of the facts would be required to certify, under penalties of perjury, that the disclosure statement is true, accurate and complete.

b. The Tax Return Disclosure requirement also would apply to all Reportable Transactions regardless of the dollar amounts involved. This requirement would be satisfied by attaching a copy of any required 30-day Disclosure, together with disclosure of any material changes in law or facts since the time of entering into the transaction, and identifying which Tax Shelter Indicators describe the transaction.

c. Although described by one or more Tax Shelter Indicators, certain transactions would be exempt from the disclosure requirements outlined above. First, to the extent provided by regulations, transactions and arrangements that are properly reported on certain forms specifically prescribed for arrangements of that type would not be treated as Reportable Transactions. In this regard, the JCT Study suggests that such regulations would provide exemptions from both the 30-day Disclosure and Tax Return Disclosure requirements for taxpayers that file Form 1120–FSC (with respect to foreign sales corporations), Form 1120–DISC (with respect to domestic international sales corporations), Form 8586 (with respect to the low income housing credit), Form 1120, schedule K, line 12 (with respect to tax exempt interest), and Form 8860 (with respect to the qualified zone academy bond credit). Second, an exception to the 30-day Disclosure requirement—but not Tax Return Disclosure—would be automatically provided (regardless of regulations) with respect to any leasing transaction within the scope of Rev. Proc. 75–21, 1975–1 C.B. 715, to the extent that the guidelines set forth in that revenue procedure, or the relevant case law thereunder, are satisfied.

d. Covered Transactions that are not Reportable Transactions would be subject to a different set of disclosure requirements. The JCT Study recommends that any position taken or advised to be taken on a tax return (including with respect to Covered Transactions that are not Reportable Transactions) must be disclosed unless the reported tax treatment is more likely than not the correct tax treatment under the Code.

e. Finally, the JCT Study would require any corporate taxpayer that is required to pay an understatement penalty of at least $1 million attributable to a corporate tax shelter to disclose that fact to its shareholders. Such disclosure would be required to indicate both the amount of the penalty and the factual setting under which the penalty was imposed.

2. Tax Shelter Registration

The JCT Study also recommends modifying the rules with respect to registration of corporate tax shelters. Under current law, Section 6111 requires any tax shelter organizer to register the tax shelter with the IRS not later than the first day on which the first offering for interests in the tax shelter occurs. Congress enacted Section 6707 to impose a penalty for the failure to timely register tax shelters under Section 6111; because the Treasury Department has not yet promulgated the implementing regulations, Section 6707 has not yet taken effect. When those regulations are promulgated, the penalty under Section 6707 for the failure to timely register

a tax shelter will be equal to the greater of (i) fifty percent of the fees paid all promoters of the tax shelter with respect to offerings made before the date the tax shelter is registered or (ii) $10,000. If the promoter does not register and is not a U.S. person, then any potential participant in the tax shelter must register within ninety days unless it notifies the promoter that it will not participate.

a. The current standard under Section 6111(d)(1) for triggering the tax shelter registration requirements is that the tax shelter involve any entity, plan, arrangement or transaction: (i) where a significant purpose of the structure is the avoidance or evasion of federal income tax for a direct or indirect corporate participant, (ii) which is offered to any potential participant under conditions of confidentiality and (iii) for which the tax shelter promoters may receive fees in excess of $100,000 in the aggregate.

b. The JCT Study recommends modifying this standard in two respects. First, the requirement that an arrangement be offered under conditions of confidentiality would be replaced with a requirement that the arrangement (or the tax analysis underlying the arrangement) is reasonably expected to be presented to more than one potential participant. Second, the threshold for promoter fees would be increased from $100,000 to $1 million in aggregate fees expected to be received from the specific arrangement and all similar arrangements.

Because the first criteria set forth in Section 6111(d)(1) corresponds to the corporate tax shelter definition provided in Section 6662 (i.e., that a significant purpose of the structure or arrangement be the avoidance or evasion of federal income tax for a direct or indirect corporate participant), it appears that the tax shelter registration requirements will apply to all Covered Transactions (including, but not limited to, Reportable Transactions).

c. In the case of arrangements that are described by one or more Tax Shelter Indicators (i.e., Reportable Transactions), the JCT Study would require additional information to be disclosed as part of the registration process. This would include a description of (i) the claimed tax treatment of the arrangement and a summary of the authorities for the positions taken; (ii) the calculations for the arrangement under a reasonable set of hypothetical facts (including any calculations used to determine that the arrangement is described by a Tax Shelter Indicator); and (iii) the reasons why the arrangement is reasonably expected to be considered a tax shelter because of the presence of one or more Tax Shelter Indicators.

General Framework for Addressing Corporate Tax Shelters

We believe that an appropriate framework for addressing corporate tax shelters requires an evaluation of the true scope of the perceived problem; the ability of the Treasury Department and the IRS to identify imperfections in our tax system through the tools it already has at its disposal; and the ability of the government to address the problems that it does identify, either through the rulemaking process or through the courts. Only when the Treasury Department and the IRS do not have the necessary tools to address the problems they identify, or when the Treasury Department identifies problems that it cannot address through its existing regulatory authority, should the Congress provide additional tools and delegations of authority to the Treasury Department and the IRS. To the extent that the Congress determines that such additional tools or delegations are necessary, we agree with the JCT's conclusions that such tools or delegations should not interfere with legitimate tax planning or impose needless complexity, and would also suggest that such tools should not result in arbitrary or hidden tax increases or violate basic notions of fairness and equity.

A. The First Step of Any Analysis Should Be to Assess The Causes And Severity of The Problem And to Ensure That Any Remedy Does Not Risk Causing More Harm Than Good

The rhetoric and anecdotal press accounts that have surfaced surrounding corporate tax shelters suggest that the corporate tax base is rapidly eroding and in imminent danger of imploding. While we understand that the perception of a problem is itself a problem that may require attention, the data we have reviewed simply does not support claims that the corporate tax base is at risk.[16]

[16] The following table is compiled from data set forth in Office of Management and Budget, Historical Tables, Budget of the United States Government, Fiscal Year 2000 (February 1999).

Corporate Income Tax Receipts

Year	Corporate income tax receipts	Total receipts	Percent of total	Percent of GDP
FY1989	$103,291,000	$991,190,000	10.4	1.9
FY1990	$93,507,000	$1,031,969,000	119.1	1.6
FY1991	$98,086,000	$1,055,041,000	9.3	1.7
FY1992	$100,270,000	$1,097,279,000	9.2	1.6
FY1993	$117,520,000	$1,154,401,000	10.2	1.8
FY1994	$140,385,000	$1,258,627,000	11.2	2.1
FY1995	$157,004,000	$1,351,830,000	11.6	2.2
FY1996	$171,824,000	$1,453,062,000	11.8	2.3
FY1997	$182,293,000	$1,579,292,000	11.5	2.3
FY1998	$188,677,000	$1,721,798,000	11.0	2.2

These statistics indicate that, despite the Administration's assertions that corporate tax shelters have severely eroded the corporate tax base, corporate taxpayers in the United States have paid more money to the Federal government for each of the past nine years, and that the percentage of corporate income tax receipts as compared to both total Federal receipts and gross domestic product has remained steady over the past decade. Moreover, the Administration's estimates for the next five years indicate that this trend will continue, with corporate income taxes as a percentage of gross domestic product remaining at approximately 2.1 percent for each of those years and annual corporate payments continuing to trend up. Indeed, the Administration's own revenue estimates suggest that the scope of the corporate tax shelter problem is limited. The Administration estimates that its six generic tax shelter proposals would increase revenues by $1.76 billion over five years—less than 0.2% of total projected corporate tax receipts over that period. Of this amount, $830 million relates to the proposal to tax income attributable to tax indifferent parties.

One of the reasons cited by government agencies and officials for surpluses higher than expected over the past couple years, and in the future, is a stronger than expected economy resulting in higher than expected corporate profits and unparalleled job growth, which in turn result in higher than expected tax revenue. Domestic businesses have become more efficient in their business operations and have been able to employ more workers and raise capital to effectively compete in the global market place.

The Congressional Budget Office ("CBO") notes that "corporate profits are beginning to be squeezed by higher labor costs and the inability of firms to raise prices in the face of strong opposition from home and abroad."[17]

CBO also notes that corporate profits will decline primarily because of a projected increase in gross domestic product devoted to depreciation.[18]

CBO predicts that some decline in corporate profits from recent levels is "inevitable" because of the sensitivity of corporate profits to business-cycle fluctuations.[19]

In an era of projected budget surpluses, the size of which is due in part to increased employment and corporate profits (and taxes thereon), the Congress should require compelling evidence of the need for enacting proposals that would restrict the ability of corporate taxpayers to operate efficiently and respond to changing market conditions. This is especially true when CBO is predicting increased pressures on future corporate profits.

As the JCT Study states, no direct measure of loss in tax revenues attributable to corporate tax shelters is currently available. But, with corporate profits steadily increasing, and with corporate income tax receipts likewise accelerating, the burden should rest on those who are calling for a new and enhanced system to substantiate their claims of an imploding revenue base. The burden should not be placed on taxpayers to prove that they should be paying even more income taxes in order to avoid new penalties. Moreover, as noted above, the Congress should act judiciously in this area. Due to the current revenue estimating conventions, once the Treasury Department and IRS receive new delegations of authority to attack corporate tax shelters, any attempt to curb that authority would be scored as resulting in a revenue loss.

Accordingly, Congress should not let anecdotal evidence and targeted press accounts attacking various transactions lead to legislation that does more harm than good. The threshold for enacting legislation in this area remains high. Tax shelters do not threaten the corporate tax base. Any responses to the problem, when appro-

[17] CBO, Economic and Budget Outlook, Fiscal Year 2000–2009, January 1999, p. 24.
[18] *Id.* at 27.
[19] *Id.*

priately articulated, should not impose complex and overreaching rules that undermine the ability of domestic businesses to operate efficiently, and thereby undermine the job creation and corporate profits that ultimately generate the long-term growth of Federal revenues.

B. Treasury Has Several Existing Tools to Combat Corporate Tax Shelters Which Should Be Evaluated Before Piling on New Ones

Much of the rhetoric relating to the "corporate tax shelter" issue suggests that the government needs new tools because it is not aware of transactions and tax planning arrangements which it might deem inappropriate. That is why the Administration proposed numerous specific provisions to attack transactions that it does not like, plus the general provisions, such as that proposed in the Doggett Bill, in case there are others which they have not yet found.[20] The JCT Study, like the White Paper, appears to embrace the notion that new tools are required even before undertaking a thorough analysis of the existing powers that the Administration has at its disposal.

The IRS has several existing and some new tools at its disposal to identify corporate tax shelters. Before enacting new proposals, existing rules and authorities should be carefully and thoroughly reviewed. If they do not work or are inadequate perhaps they should be repealed and replaced with new ones. Adding another layer of penalties and rules to overlay existing ones merely creates more complexity and potential pitfalls for taxpayers. It is contrary to the intent of Congress in mandating the JCT Study and requiring a review of the "administration and implementation by the Internal Revenue Service of interest and penalty provisions of the [Code] and to make any legislative or administrative recommendations the JCT deems appropriate to *simplify penalty or interest administration and to reduce taxpayer burden*."[21]

As recently as 1997, the Congress enacted a law that expanded the definition of what qualifies as a "tax shelter" for purposes of registering such transactions with the IRS.[22] When Treasury proposed the registration provision in February 1997, it explained that the provision would help get the IRS useful information about corporate deals at an early stage to help identify transactions to audit and then take appropriate action—presumably through enforcement, regulatory changes, and requests for legislation when necessary.[23] The filing requirement becomes effective when Treasury Regulations are prescribed. To date, such regulations have not been issued. One explanation for the delay may be the concern that the 1997 amendment is limited to transactions offered under conditions of confidentiality, and that taxpayers will simply enter into transactions without such conditions in order to avoid application of the new rules. Nonetheless, there appears to have been little effort to assess the effectiveness of existing programs,[24] as expanded in 1997, or to correct any perceived flaws in the 1997 amendments, before making wholesale changes to these rules.[25]

The expansive definition of tax shelters for purposes of the tax shelter registration provision was also carried over to Section 6662, the substantial understatement penalty provision. Accordingly, the increased exposure to the substantial understatement penalty, as a result of the 1997 changes, is virtually brand new and has not

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[20] In the White Paper, Treasury recommended (i) significantly increased disclosure; (ii) a significantly harsher penalty structure; (iii) a substantive change in law such as that proposed in the Doggett Bill; and (iv) additional penalties and excise taxes on promoters, advisors and tax-indifferent parties that participate in corporate tax shelters.

[21] *See JCT Press Release, 98–2 (December 21, 1998) (emphasis added).*

[22] *See* Section 1028 of the Taxpayer Relief Act of 1997(enacting Section 6111(d)).

[23] *See* the U.S. Treasury Department's *General Explanations of the Administration's Revenue Proposals*, at 81 (February 1997). According to Treasury:

> Many corporate tax shelters are not registered with the IRS. Requiring registration of corporate tax shelters would result in the IRS receiving useful information at an early date regarding various forms of tax shelter transactions engaged in by corporate participants. This will allow the IRS to make better informed judgments regarding the audit of corporate tax returns and to monitor whether legislation or administrative action is necessary regarding the type of transactions being registered.

[24] Section 6111 was added to the Code in the Tax Reform Act of 1984. In 1989, the Commissioner's task force *Report on Civil Tax Penalties* concluded that "[v]irtually no empirical data exists" about the Section 6111 penalty (VI–22 and n. 29 (1989)).

[25] Commentators view the rules enacted in 1997 as quite expansive. *See*, Mark Ely and Evelyn Elgin, New Tax Shelter Penalties Target Most Tax Planning, Tax Notes (December 8, 1997); Sheryl Stratton, *Restructuring Agreement would Expose Tax Shelter Opinions*, Tax Notes (June 23, 1998).

been assessed.[26] In this case, unlike the registration requirement discussed above, there is no requirement that the arrangement involve a corporation, a confidentiality agreement or minimum promoter fees. As a result, it is worth noting, that under current law a corporate taxpayer can fully disclose a position on a tax return and can have substantial authority for such position but still be subject to penalty if the transaction is considered a tax shelter. The only way to avoid a penalty is to establish reasonable cause under Section 6664(c) which, by regulation, Treasury has already circumscribed so that for example, a taxpayer's reasonable belief that it is more likely than not to prevail may not be sufficient.[27]

Many have argued that the success of the 1997 changes to the substantial understatement penalty rules will turn on how artfully the term "tax shelter" is defined by the Treasury Department and enforced by IRS agents. There is great concern in the business community that the expanded definition will provide a strong incentive for revenue agents to set up penalties as bargaining chips in negotiations. Before considering giving these agents more authority, it is important to evaluate the effect of these most recent changes. It is premature to explore new proposals even before the most recent changes take effect.

Disclosure of appropriate information to the IRS is an important element of successful tax enforcement. As indicated above, Congress approved enhanced disclosure of tax shelters in the Taxpayer Relief Act of 1997 by adopting provisions that the IRS and Treasury have not yet implemented. This is on top of existing disclosure requirements. In this regard, we note that corporate taxpayers generally are required to reconcile their book and taxable income on the face of the corporate income tax return.[28] Thus, corporate taxpayers already are required to disclose (and must be prepared to explain and justify) the book/tax differences that the Administration and the JCT Staff view as a key indicator of potential corporate tax shelter transactions.[29] Moreover, the largest 1,700 corporate taxpayers are included in the coordinated examination program[30] and are subject to continuous audit by revenue agents who routinely work from offices at the taxpayer's headquarters and have the time and access to all of the information necessary to identify potential corporate tax shelters.[31]

C. The IRS Regularly Identifies Imperfections in Our Tax System Through the Tools It Already Has at Its Disposal

As a practical matter, when the government does identify what it perceives as "abuses," the IRS has often been aggressive in challenging those transactions through examination and litigation.

1. Litigation

Significant cases that the government has won in recent years include: *Ford Motor Co. v. Commissioner*, 102 T.C. 87 (1994), *aff'd* 71 F.3d 209 (6th Cir. 1995) (Tax Court limited a current deduction for a settlement payment, stating that tax treatment claimed by the taxpayer would have enabled it to profit from its tort liability); Jacobs Engineering Group, Inc. v. United States, 97–1 USTC 87,755 (CCH ¶ 50,340) (C.D. Cal. 1997), *aff'd* 99–1 USTC 87,786 (CCH ¶50,335) (9th Cir. 1999) (applying Section 956 to a transaction despite the fact that a literal reading of the regulations would not have subjected the taxpayer to that provision); *ACM Partner-*

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[26] As suggested by the staff of the JCT in its description of the Administration's revenue proposals, "it may be premature to propose new measures to deal with corporate tax shelters when provisions have already been enacted that are intended to that, but where there has been no opportunity to evaluate the effectiveness of those already-enacted provisions because they have not yet become effective because of the lack of the required guidance." Staff of the JCT, *Description of Revenue Provisions Contained in the President's Fiscal year 2000 Budget Proposal*, JCS–1–99 at 165 (Feb. 22, 1999) (hereinafter the "JCT Report").

[27] Treas. Reg. Section 1.6664–(4).

[28] Internal Revenue Service Form 1120, Schedule M–1.

[29] The White Paper and the JCT Study both suggest that the Schedule M–1 is not a useful audit tool, and that negotiations over audit plans allow taxpayers to hide corporate tax shelter issues. This is simply not the case. The IRS invariably uses the Schedule M–1 as a road-map for conducting its audits, and one of the first requests made by the IRS in any audit of a large corporation is a request for a detailed explanation of book/tax differences.

[30] GAO, "Tax Administration—Factors Affecting Results from Large Corporations," p. 1, GAO/GGD—97–62 (Apr. 1997).

[31] Despite the assertion made in the JCT Study that "audits of large corporations typically follow an agreed-upon agenda of issues that is negotiated by the IRS and the corporate taxpayer," in practice we have found that the IRS determines which issues will be covered by an audit, and that the IRS will continue to raise new issues throughout the audit process. Thus, the notion that corporate taxpayers can "win the audit lottery" by negotiating the initial agenda for an audit does not reflect the reality of how the IRS conducts audits.

ship v. Commissioner, 73 T.C.M. (CCH) 2189 (1997), *aff'd* 157 F.3d 231 (3d Cir. 1998) (not respecting a partnership's purchase and subsequent sale of notes, stating that the transaction lacked economic substance) *cert. denied* 119 S. Ct. 1251 (1999); *ASA Investerings Partnership v. Commissioner*, 76 T.C.M. (CCH) 325 (1998) (applying an intent test to determine that a foreign participant in a partnership was a lender, rather than a partner, for federal income tax purposes); *United Parcel Service of America, Inc. v. Commissioner*, T.C.M. No. 268 (1999) (treating an intragroup restructuring involving a related insurance company as a sham, stating that the restructuring was primarily motivated by tax considerations); The *Limited Inc. v. Commissioner*, 113 T.C. No. 13 (1999) (holding in favor of the IRS on grounds that the principal purpose for organizing a foreign subsidiary to purchase certificates of deposit from a domestic subsidiary, rather than using a domestic corporation, was to avoid the application of Section 956); *Compaq Computer Corp. v. Commissioner*, 113 T.C. No. 17 (1999) (holding that the economic substance doctrine applied to deny foreign tax credits attributable to the purchase and resale of ADRs when the transaction was (i) designed to yield a specific result and eliminate all economic risks, (ii) the taxpayer had no reasonable possibility of a pre-tax profit and (iii) the taxpayer had no non-tax business purpose for the transaction); *IES Industries, Inc. v. United States*, No. C97–206 (N.D. Iowa September 22, 1999) (order granting partial summary judgment in favor of IRS under facts similar to *Compaq*); *Winn-Dixie v. Commissioner*, 113 T.C. No. 21 (1999) (holding that a leveraged corporate-owned life insurance program lacked economic substance and business purpose when the court found that the only function of the program was to generate interest and fee deductions in order to offset income from other sources); and *Saba Partnership v. Commissioner*, T.C.M. No. 359 (1999) (applying economic substance test to disregard partnership transactions similar to those addressed in *ACM Partnership* and *ASA Investorings Partnership*).

Of particular note is that in *UPS* and *Compaq* the IRS asserted, and the courts sustained, the imposition of meaningful penalties on the taxpayers. This suggests that the current law penalty provisions are being used, despite an assertion to the contrary in the JCT Study.

2. Administrative Action

Likewise, the Administration regularly addresses what it perceives as "abuses" through notices and regulations. In recent years, the Treasury Department has promulgated a number of regulations and other rules intended to stop tax planning activities that the Treasury Department has viewed as inappropriate. These include the partnership anti-abuse regulations,[32] the proposed regulations targeting certain partnership transactions involving a partner's stock,[33] the anti-conduit financing regulations,[34] the temporary regulations targeting the improper use of tax treaties by hybrid entities,[35] the recently proposed regulations targeting fast-pay stock arrangements,[36] the recently released revenue ruling attacking certain leasing transactions,[37] the recently proposed regulations targeting certain transactions involving foreign hybrid entities[38] and the recently proposed regulations targeting certain charitable remainder trust arrangements.[39]

Moreover, on a number of occasions in recent years, the Treasury Department has issued notices to target specific tax planning techniques, typically announcing its intention to issue regulations addressing such techniques that will be effective as of the date of the notice. Examples of this approach include notices attacking certain partnership transactions,[40] inversion transactions,[41] transactions involving the acquisition or generation of foreign tax credits[42] and transactions involving foreign hybrid entities.[43] On several occasions, the regulatory guidance has been issued

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[32] Treas. Reg. § 1.701–2.
[33] Prop. Treas. Reg. § 1.337(d)–3.
[34] Treas. Reg. § 1.881–3; Prop. Treas. Reg. § 1.7701(l)–2.
[35] Temp. Treas. Reg. § 1.894–1T.
[36] Prop. Treas. Reg. § 1.7701(l)–3.
[37] Rev. Rul. 99–14, 1999–13 I.R.B. 3.
[38] Prop. Treas. Reg. § 1.954–9.
[39] Prop. Treas. Reg. § 1.643(a)–8.
[40] Notice 89–37, 1989–1 C.B. 679.
[41] Notice 94–46, 1994–1 C.B. 356.
[42] Notice 98–5, 1998–3 I.R.B. 49.
[43] Notice 98–11, 1998–6 I.R.B. 13.

with retroactive effective dates, a practice that is likely to have a chilling effect on transactions that taxpayers believe the government might find "abusive."[44]

3. Targeted Legislation

Under the present system, when the Treasury Department identifies a perceived "abusive" transaction, whether through rulemaking or by way of a specific legislative proposal, the Congress has not hesitated to enact legislation to curb transactions that it perceives as inappropriate. For example, last year the Congress eliminated certain tax benefits involving the liquidation of a regulated investment company or real estate investment trust. In addition, just several months ago the Congress enacted a provision to address certain transactions involving the transfer of property subject to multiple liabilities. While in each case the statute was effective as of the date of announcement, the Congress made clear (as it does routinely in perceived abuse cases) that the IRS was free to attack pre-effective date transactions under prior law.

The events that unfolded over the past eighteen months following the release of Notice 98–11,[45] and the Congress' repeated rejection of most of the Administration's proposed revenue raisers, highlight another issue that should be considered in light of the proposals to provide the IRS and the Treasury Department with new ways to combat transactions that they view as inappropriate. We respectfully submit that the new arsenal of weapons recommended by the JCT Study would effectively allow the IRS and Treasury to accomplish what the Congress has effectively prevented in the legislative arena. Moreover, even when the Congress and the Treasury Department agree that a problem exists, they may not agree on the appropriate solution.

Department agree that a problem exists, they may not agree on the appropriate solution.

We are not suggesting that there are no transactions that generate unanticipated and inappropriate tax consequences. To the contrary, these results are the inevitable outcome of a tax system that is too complex and burdensome. We also recognize the obvious—taxpayers and their advisors move quickly to take advantage of perceived tax planning opportunities. Nevertheless, wholesale new laws with vague and punitive components can do more harm than good.

D. Criteria That Should Be Used in Evaluating Legislative Proposals to Address Corporate Tax Shelters

To the extent that Congress determines that legislative action is required to address corporate tax shelters, such action should be commensurate with the problem. Moreover, Congress should balance carefully the expected benefit of any legislative proposal with the likely adverse consequences of enacting such a proposal. In particular, we respectfully suggest that no legislative proposal should be enacted that would: interfere with mainstream business transactions and ordinary tax planning activities; impose needless complexity; violate basic notions of fairness and equity or result in an arbitrary or hidden tax increase.

1. Any Legislative Solution Should Not Interfere with Mainstream Business Transactions and Ordinary Tax Planning Activities

No legislative solution to the perceived corporate tax shelter problem should undermine routine business transactions and tax planning. As Judge Learned Hand observed over sixty years ago:

> A transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best

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[44] *See* Section 7805(b)(3) (authorizing Treasury to issue regulations retroactively when necessary to prevent abuse, but only with respect to statutory provisions enacted on or after July 30, 1996).

[45] In Notice 98–11, the IRS and Treasury announced their intention to propose regulations targeting certain transactions involving foreign hybrid entities. Less than three months after the issuance of Notice 98–11, temporary regulations implementing the notice were promulgated. As a result of a significant legislative backlash to those temporary regulations, which generally focused on whether the targeted transactions were in fact inappropriate and whether Treasury had the authority to issue the regulations, the IRS and Treasury issued Notice 98–35, in which they expressed their intent to revise the temporary regulations with a new effective date. Those regulations were proposed on July 9, 1999, with a proposed effective date of no earlier than 2006.

> pay the Treasury; there is not even a patriotic duty to increase one's taxes.[46]

All of the tax policy makers in the current debate on corporate tax shelters—including the Chairman of the House Committee on Ways and Means,[47] the Chairman of the Senate Committee on Finance,[48] the Treasury Department[49] and the JCT[50]—agree that legislation should not inhibit legitimate business transactions and tax planning activities.

The question that must be answered is whether the proposals contained in the White Paper and the JCT Study impede legitimate tax planning (i.e., the activities described by Judge Hand as an integral part of our tax system). For the reasons set forth below, the answer to this question is yes. It is clear that they would have precisely the chilling effect that all involved have said they wish to avoid.

2. Any Legislative Solution Should Not Impose Needless Complexity

When discussing our tax system, there is only one complaint that is universally shared—the system is far too complex and must be simplified. In this regard, it is important to note that complexity can be both substantive and procedural. Substantive complexity arises at one extreme when the operative definitions and rules are crafted so broadly that they cannot be reasonably and uniformly applied; it arises at the other extreme when taxpayers are required to navigate a labyrinth of rules in order to determine which substantive rules will apply. Procedural complexity arises when, for example, taxpayers are subject to burdensome reporting or record-keeping requirements, or must engage in costly and protracted disputes with the government.

The question that must be answered is whether the proposals contained in the White Paper and the JCT Study lead to significant substantive procedural complexity. For the reasons set forth below, the answer to this question is yes.

3. Any Legislative Solution Should Not Violate Basic Notions of Fairness and Equity

One of the striking aspects of the proposals to address corporate tax shelters is the apparent failure to consider standards of basic fairness and equity. These concepts are, of course, difficult to define in practice. However, we believe that the fairness and equity of the proposals under consideration can be addressed by considering questions such as the following:

- Do the proposals create a structural bias that will cause taxpayers to systematically over-pay their taxes?
- Do the proposals give IRS revenue agents the authority to extract inappropriate concessions from taxpayers?
- Do the proposals permit the government to avoid accountability for the rules that it writes?
- Do the proposals impose standards on taxpayers and third parties that are far more onerous than the standards imposed on the government?

Unfortunately, for the reasons set forth below, the answer to each of these questions is likely to be yes. As a result, the proposals under consideration do violate basic notions of fairness and equity.

4. Any Legislative Solution Should Not Result in an Arbitrary or Hidden Tax Increase

If the goal of corporate tax shelter legislation is to create incentives in our self-assessment system for taxpayers to file tax returns that reflect the actual amount of tax required to be paid under the law, then any such legislation should not be crafted as a tax increase in disguise. If Congress wishes to raise taxes, it can do so directly.

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[46] *Helvering v. Gregory*, 69 F.2d 809, 810 (2nd Cir. 1934), aff'd 293 U.S. 465 (1935).

[47] *Tax Bill Will Include Extenders, Some Shelter Provisions, Archer Says*, 1999 TNT 56–1 (March 23, 1999) (quoting Rep. Archer, Chairman of the House Committee on Ways and Means, to the effect that [Chmn. Archer] "wants to proceed more cautiously and doesn't want to injure taxpayers who are trying to legally reduce their tax liabilities in the push to catch those who abuse the system").

[48] *Finance Committee to Review Tax Code Penalties, Including Corporate Tax Shelter Proposals*, News Release from Sen. Roth (July 13, 1999) ("Corporate tax shelters should be curtailed without affecting legitimate business transactions.")

[49] *Hearing on the President's Fiscal Year 2000 Budget Before the House Committee on Ways and Means*, 106th Cong., 1st Sess. (1999) (statement of Hon. Donald Lubick, Assistant Secretary (Tax Policy), U.S. Department of the Treasury) ("The Treasury Department does not intend to affect legitimate business transactions.")

[50] JCT Study at 219 (stating that the tax system must not impede taxpayers' ability to conduct business).

The question that should be asked is whether the proposals under consideration would result in an arbitrary or hidden tax increase because they:

- create strong structural incentives for taxpayers to overpay their taxes;
- give IRS revenue agents weapons that they can use to extract inappropriate concessions from taxpayers;
- impose penalties on third parties that would likely be borne by corporate taxpayers; and
- impose dead-weight costs in the form of substantial compliance and administrative burdens.

Unfortunately, again for the reasons explained below, the answer to these questions is likely to be yes. While presumably unintended, the proposals would result in a hidden tax increase on corporate taxpayers.

IV. Specific Comments on the JCT Study's Recommendations

The JCT Study suffers from two fundamental flaws. First, the JCT Study fails to establish a plausible case that the Treasury Department and the IRS do not have the necessary tools to address the problems that they identify, and accordingly presumes the need for the creation of new and enhanced penalties. To be sure, the JCT Study provides evidence of the perception of a corporate tax shelter problem; however, the only real evidence of a problem with the enforcement tools already available to the IRS is the JCT's assertion that the IRS too often is willing to waive the imposition of penalties.[51] As the recent decisions of the Tax Court in UPS and Compaq demonstrate, the IRS does assess, and the courts do impose, substantial penalties in the context of "tax motivated" transactions. Second, even if the Congress were to determine that a legislative response is appropriate, the JCT Study's recommendations violate the criteria outlined above for evaluating proposed statutory changes: they would interfere with ordinary tax planning activities, they would result in additional complexity, they would result in arbitrary or hidden tax increases, and they would violate basic notions of fairness and equity.

Following are comments on the specific proposals, and an evaluation of those proposals in light of the general framework suggested above.

A. Comments on Specific Proposals

The Proposed Definition of Corporate Tax Shelters is Overly Broad and Needlessly Complex

Section 6662(d)(2)(C)(ii) defines the term "tax shelter" for purposes of the substantial understatement penalty as:

> A partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

This definition, which turns on the meaning of a "significant purpose," is widely viewed as extremely broad and uncertain. Indeed, it is arguable that the definition encompasses all matters where tax planning is involved because the essence of tax planning is to "avoid" tax liabilities that would otherwise arise if the transaction or activity were structured or conducted in some other way.[52] Under current law, the ramifications of this open-ended definition are limited to procedural matters (e.g., the imposition of a twenty percent penalty if a substantial understatement results, unless the taxpayer has substantial authority for its position and reasonably believed that it was more likely than not to prevail on the merits.) Under the JCT Study's proposal, however, the uncertainty inherent in the definition of a "corporate tax shelter" would have far more serious consequences (e.g., a taxpayer that engages in a Covered Transaction but misapprehends the need to disclose would face a mandatory forty percent penalty if the taxpayer loses on the merits).

The breadth of the underlying definition of "corporate tax shelter" is neither circumscribed nor clarified by the addition of the five Tax Shelter Indicators. As ex-

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[51] JCT Study at 220 (citing David C. Garlock, *A Tax Executive's Guide to Evaluating Tax-Oriented Transactions*, 17 Tax Mgmt. Wkly. Rep. 370 (1998) (noting, without providing any empirical evidence, that the IRS routinely threatens penalties and offers to waive them in settlements)). Moreover, to the extent that the JCT Study does provide statistics with regard to abatement of interest and penalties, those statistics do not necessarily portray the whole picture, which is that the IRS often "trades" penalties in exchange for concessions by taxpayers on other issues as part of the settlement process.

[52] We recognize that the word "avoid" may have negative connotations; however, since the time of Judge Hand's assertion in *Gregory*, the "avoidance" of taxes is a universally accepted description of legitimate tax planning.

plained below, the Tax Shelter Indicators are explicitly intended to encompass routine tax planning activities and are potentially vague and subjective in their application.[53]

a. The reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected net tax benefits. For purposes of this factor, the JCT Study states that the present value of the relevant amounts would be determined using a discount rate equal to the short-term applicable Federal rate plus one percentage point (100 basis points). The use of this mandatory discount rate in valuing cash flows would mean that many financing and pre-tax arbitrage transactions (when the market routinely seeks profits measured in less than 100 basis points) could be covered. A review of basic data that everyone in the bond market has access to supports the conclusion that the proposed discount rate does not reflect what goes on in the "real world." Concerns regarding the potential implications of this rule are amplified by the fact that, as noted below, the JCT Study views an investment in tax-exempt bonds as a corporate tax shelter, presumably based on an application of this mandatory discount rate. Indeed, nearly every purchase of preferred stock or tax-exempt bonds would be below the yield indicated by the mandatory discount rate.

b. The arrangement involves a tax-indifferent participant, and (a) results in taxable income materially in excess of economic income to the tax-indifferent participant; (b) permits a corporate participant to characterize items in a more favorable manner or (c) results in a non-economic increase, creation, multiplication or shifting of basis. The use of a Tax Shelter Indicator that turns on the participation of a tax-indifferent party is troubling for several reasons. First, the targeting of transactions that involve categories of taxpayers that the Congress has determined are worthy of exemption from tax, including Native American tribal organizations and other tax-exempt organizations, effectively overrides the tax exemptions that such organizations currently enjoy. If the Congress determines that there are circumstances in which these organizations should be taxed, a more appropriate approach would be to either repeal their exemptions or expand the scope of the unrelated business income tax. Second, the use of tax-indifferent parties in the definition of a corporate tax shelter would create a new kind of uncertainty for other taxpayers that participate in the transaction, in that such participants could wind up subject to deficiencies and penalties for the simple reason that they did not know whether another party to the same transaction falls within the proposed definition of a tax-indifferent participant.[54]

c. The reasonably expected net tax benefits are significant, and the arrangement involves a tax indemnity or similar agreement for the benefit of the corporate participant other than a customary indemnity in an acquisition or other business transaction entered into with a principal in the transaction. The JCT Study's discussion of "customary indemnity agreements" fails to consider a host of transactions in which a tax indemnity is provided in the ordinary course. A few of the many examples include the dividends received deduction indemnity that accompanies every private placement of preferred stock and the withholding tax indemnity that accompanies every cross-border securitization or financing. Depending upon how the "customary" standard is interpreted, this factor could sweep in a large number of routine business transactions.

d. The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is reasonably expected to create a "permanent difference" for U.S. financial reporting purposes under generally accepted accounting principles. This factor alone would apply to numerous routine business activities and transactions, including many where corporate tax planning may not be a significant consideration.[55] Some of the more common examples involve stock options, tax exempt municipal bonds, the dividends received deduction and special tax credits (e.g., low-income housing credit under Section 42). Moreover, by their nature, permanent book/tax differences are already disclosed to the IRS as part of the Form 1120 Schedule M–1 reconciliation.

e. The reasonably expected net tax benefits from the arrangement are significant and the arrangement is designed so that the corporate participant incurs little (if any) additional economic risk as a result of entering into the arrangement. The breadth of this factor is illustrated by the fact that, as currently worded, it arguably

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[53] The Doggett Bill would create a similar degree of uncertainty by retaining the vague definition of current law and adding a new definition for "noneconomic tax attributes."

[54] The Doggett Bill also inappropriately targets transactions involving tax-indifferent parties.

[55] Similarly, the Doggett Bill would create a presumption that tax benefits should be disallowed when the benefits "are not reflected...on the taxpayer's books and records for financial reporting purposes."

covers all borrowings (because, as commonly understood, the lender is the party taking the risk), hedging transactions, defeasance transactions, insurance transactions, credit support transactions (including guarantees and letters of credit), and all transactions among members of an affiliated group (including all financing transactions, intercompany transactions and arrangements regarding the repatriation of dividends). While this may not have been intended, it is a straight-forward reading of the proposal—and certainly a reading that enterprising IRS agents might assert.

The extraordinary breadth of the corporate tax shelter definition, and the list of Tax Shelter Indicators, is best illustrated by example. One starting point is the routine corporate tax planning transactions that the JCT Study itself acknowledges are Covered Transactions. The JCT Study treats all of the following as Reportable Transactions, meaning that they are all Covered Transactions described by one or more Tax Shelter Indicators:

All leveraged lease transactions. The JCT Study would exempt lease transactions that satisfy the criteria of Rev. Proc. 75–21 (or the relevant case law thereunder) from the 30-day Disclosure requirement, acknowledging that the volume of these transactions is so significant that disclosure would be unduly burdensome on both taxpayers and the IRS. Nonetheless, the JCT Study apparently views all leveraged leasing transactions as "corporate tax shelters," presumably because the typical pretax profit of one to four percent that investors expect in a leveraged lease transaction would fall short under the mandatory discount rate that the JCT staff recommended, even though one to four percent would be significantly more than the *de minimis* standard of *Sheldon v. Commissioner*, 94 T.C. 738 (1990). Thus, one of the most common techniques for raising capital to finance airplane acquisitions and acquisitions of heavy equipment by utilities and others—transactions that have been expressly sanctioned by the IRS and serve an important function in the domestic and international capital markets—are tainted with the "corporate tax shelter" label. In this regard, it is also worth noting that numerous leveraged lease transactions fail (or arguably fail) to meet one or more of the Rev. Proc. 75–21 requirements yet are routinely respected as true leases by the IRS. Presumably, however, any leveraged lease transaction that does not satisfy the criteria of Rev. Proc. 75–21, even if otherwise sanctioned as a true lease, could be subject to these reporting requirements.

Investments in low-income housing projects, tax exempt bonds, foreign sales corporations ("FSCs") and Domestic International Sales Corporations ("DISCs") The JCT Study recommends that the Secretary be allowed to provide an exemption from the 30-Day and Tax Return Disclosure requirements for corporate taxpayers that avail themselves of these provisions of the Code. Presumably, investments in low income housing and tax exempt bonds are Reportable Transactions because they fail to satisfy the minimum return standard of the first Tax Shelter Indicator. While FSC's and DISC's are Covered Transactions, it is not entirely clear why the JCT Study also views them as Reportable Transactions. It is also interesting to note that the JCT Study did not include corporate investments in preferred stock as potentially exempt from the Tax Return Disclosure requirements. The volume of these transactions is, if anything, greater than the volume of leasing and tax exempt bond transactions. By treating tax advantaged investments that Congress has specifically sanctioned as Covered Transactions, and therefore corporate tax shelters per se, the JCT Study demonstrates the breadth of its definition. (Indeed, it even goes beyond the White Paper, which would presume such investments to be outside the scope of its corporate tax shelter proposals.)

An endless number of ordinary tax planning activities arguably are encompassed by the general corporate tax shelter definition and the list of Tax Shelter Indicators. As noted below, the risk that a transaction may constitute a corporate tax shelter—or that a revenue agent may threaten to treat a transaction as a corporate tax shelter—triggers a chain of events ranging from mandatory filing of additional information to the imposition of draconian penalties. These consequences will arise routinely in the context of efforts by taxpayers "to arrange [their] affairs so that [their] taxes will be as low as possible," as Judge Hand observed was permissible, even if "actuated by a desire to avoid . . . taxation." A few of the many tax planning activities that satisfy Judge Hand's definition but would nonetheless be treated as corporate tax shelters under the JCT Study include:

Changes in capital structure. Public companies routinely engage in stock buy-back programs, often financed explicitly or implicitly with debt. In most instances, the current cash flow costs of the debt are greater than the current cash flow "costs" associated with dividends on the repurchased common stock. Such transactions likely would be treated as corporate tax shelters under the JCT's recommendations because (i) they would be covered by the general definition of a corporate tax shelter in that a significant purpose is the "avoidance of tax" through obtaining a current

interest deduction, and (ii) they would be described by at least one of the Tax Shelter Indicators because the reasonably expected pre-tax profits from the stock buyback program are insignificant relative to the reasonably expected net tax benefits.

Mergers, acquisitions and other corporate transactions. There are numerous circumstances where taxpayers engage in formalistic steps in the context of mergers, acquisitions and other corporate transactions to achieve desired tax objectives or to avoid otherwise negative tax consequences. Most of Subchapter C is predicated and administered in reliance on mechanical rules, and steps that have little or no impact on expected pre-tax profits routinely have major tax implications. Taxpayers routinely use—and the IRS routinely sanctions—these steps despite the fact that their only purpose is to "avoid" taxes that would otherwise be due but for their inclusion in the transaction. Examples include the formation of a holding company to qualify an acquisition for tax-free treatment under Section 351; using transitory entities to effectuate tax free reorganizations; using or changing a particular capital structure to achieve (or avoid) tax free treatment; and using (or avoiding use of) particular consideration to achieve (or avoid) tax free treatment. All of these transactions satisfy both the generic definition of Covered Transactions and at least one of the Tax Shelter Indicators (relating to expected pre-tax profits). Depending upon how the standard is interpreted, they may also fit within the factor dealing with transactions that have no economic risk but confer substantial tax benefits.

Routine transactions among members of an affiliated group (foreign, domestic, and cross-border). A number of foreign corporate groups establish single holding companies to serve as parent companies of their U.S. consolidated tax groups.[56] Alternatively, the foreign parent could establish separate U.S. corporate chains for each business. Invariably, these choices are driven at least in part by consideration of the tax benefits and detriments of consolidation. (The same, of course, applies to U.S. holding companies.) The decision to create or change a consolidated structure would likely satisfy both the generic definition of Covered Transactions and at least one of the Tax Shelter Indicators (relating to expected pre-tax profits). Likewise, "plans" relating to the timing and source of repatriated earnings and the routine structuring of non-US businesses by US taxpayers would satisfy both the generic definition and at least one Tax Shelter Indicator. Interestingly enough, while inter company pricing decisions are arguably not covered by the generic definition (the taxpayer is supposed to be looking for the "right" answer), inter company pricing decisions arguably meet one or more Tax Shelter Indicators because the pricing has a significant impact on the taxpayer's tax liability but may not have any overall economic impact (in terms of profitability or risk) on the consolidated enterprise.

Once again, what is important to emphasize is that all of the JCT Study's penalty and disclosure recommendations are built on the same foundation—the JCT Study's definition of corporate tax shelters. That definition encompasses the entire range of legitimate tax planning activities which, in the corporate context, covers most transactions and many routine business operations.

2. The Registration, Disclosure and Certification Requirements Would Impose Significant and Unnecessary Paperwork and Administrative Burdens on Taxpayers and Third Parties

The JCT Study identifies two reasons for their registration, reporting and disclosure recommendations: to provide the IRS with an effective "early-warning" device of new transactions that it may wish to address and to assist the IRS in the examination of taxpayers. While each of these objectives is appropriate, the requirements should be consistent with their stated purposes and should not impose unnecessary paperwork or administrative burdens on taxpayers and third parties involved in their transactions.

The disclosure recommendations set forth in the JCT Study violate these standards in several ways. Again, the starting point is the breadth of Covered Transactions. The IRS is certain to be inundated with registration forms and disclosure documents from "promoters," taxpayers and third parties, undermining the stated goal of providing the IRS with a *usable* "early warning" system. Moreover, JCT Study mandates "long-form" registration and disclosure documents, despite experience suggesting that this type of information may be far less helpful than some type of "short-form" disclosure. Finally, the 30-Day Disclosure rule for corporate taxpayers is entirely superfluous. Particularly given the breadth of the Tax Shelter Indicators and the promoter registration requirements, it will not further the early warning objective; indeed, it will make matters worse for the IRS and Treasury. The

[56] In a recent field service advice memorandum, the IRS challenged exactly this type of internal corporate restructuring, stating that the primary purpose for creating the domestic holding company was to reduce taxes. *See* FSA 1999–26011.

30-day Disclosure rule also has nothing to do with the examination of the taxpayer, because that same disclosure is required on the taxpayer's tax return.

a. The disclosure requirements on corporate taxpayers are unduly burdensome, especially given the breadth of Covered Transactions. As a preliminary matter, taxpayers would have to determine whether a Covered Transaction was also a Reportable Transaction (i.e., described by one or more of the Tax Shelter Indicators). For reasons noted above, that determination is itself quite complex. Moreover, given the scope of the Tax Shelter Indicators, the 30-day Disclosure rule would be tantamount to a year-round filing requirement that bears no relationship whatsoever to the real world process of return preparation. Because many financing transactions undergo numerous changes before closing, such a short period during which to file a detailed disclosure is impractical. The burdensome nature of this requirement is further evidenced by the fact that the same information must be provided a second time to comply with the Tax Return Disclosure Requirements.[57] Finally, by mandating long-form disclosure, the recommendation will create mountains of needless paperwork for both the IRS and corporate taxpayers in connection with transactions where there is no issue or uncertainty whatsoever regarding proper tax treatment of the disclosed item.

b. Requiring a senior executive familiar with all aspects of a transaction to sign off on corporate tax shelters is unnecessary and unduly burdensome. In the first instance, this requirement is redundant because the tax director or other senior corporate officer already signs the tax return under penalties of perjury. Moreover, in light of the breadth of the definition of a corporate tax shelter, which would encompass routine business transactions and ordinary tax planning activities, the requirement would apply to an array of transactions that should not concern the Executive Branch or the Congress, let alone the chief financial officer or other senior executives of a corporate taxpayer. In order to satisfy the certification requirements, senior executives outside the tax function would be required to devote substantial time, effort and money to business activities and tax matters having nothing to do with their corporate responsibilities.[58] Finally, the broad scope of the underlying disclosure requirement makes the certification requirement all that much more onerous.

c. The recommendation in the JCT Study that transactions be disclosed to shareholders if the understatement penalty is at least $1 million undercuts the materiality standards currently used by the SEC. It also continues a peculiar and troublesome precedent by giving the tax writing Committees direct jurisdiction over disclosures required by the securities laws. Moreover, while the JCT Study implies that disclosure would deter inappropriate tax planning because management would not want to be criticized, the opposite may well be true. In the context of a system that imposes penalties on routine tax planning, when (as described below) a corporation will be penalized even if it has a better than 50–50 chance of prevailing, an occasional penalty may be viewed (correctly) as evidence that management is properly discharging its fiduciary duties to shareholders.

d. Two other forms of administrative burden are critically important but not addressed by either the White Paper or the JCT Study. The stakes associated with disclosure and certification are quite high. The failure to make proper disclosure will trigger a forty percent penalty that cannot be waived if the matter involves a Reportable Transaction and the taxpayer loses on the merits. The failure to make proper disclosure will trigger a twenty percent penalty that cannot be waived if the matter involves a Covered Transaction that is not a Reportable Transaction if the taxpayer satisfies the substantial authority standard but does not satisfy the more likely than not standard. The certification requirement is a threat that speaks for itself in the hands of a revenue agent. Under these circumstances, taxpayers could and would be subject to two examinations by the IRS—one regarding the correctness of their tax returns and another regarding the question of whether each item challenged by the IRS was a Covered Transaction, whether each Covered Transaction was a Reportable Transaction, and whether the disclosure (if any) satisfied the long-form disclosure requirements.

Not only is this "second examination" itself a source of substantial administrative burden, but the disclosure requirements will also increase burdens associated with the examination of the taxpayer's return. This will occur for two reasons. First, any time a matter is disclosed, the IRS revenue agent will need to review the disclosure and likely feel compelled to discuss the matter with the taxpayer. Given the breadth of the definition of Covered Transactions, this will result in substantial wasted time

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[57] The Doggett Bill also would require duplicative filings, within thirty days of closing a transaction and again with the tax return.

[58] The same problem would obtain under the Doggett Bill, because it would require a statement signed by a senior financial officer as to the truth of the underlying facts.

by taxpayers and the IRS. Second, the long-form disclosure requirements can be read to require a discussion of all potential theories that the IRS could use to attack the transaction, including those that have little merit (especially, given the stakes associated with inadequate disclosure and the fact that a disclosure may be inadequate even if the facts and issues that ultimately determine the outcome of the case are fully disclosed).[59] In the real world of IRS audits, revenue agents routinely assert any and all theories to support a proposed adjustment, including many that are groundless. Under these circumstances, the disclosure requirements are a ticket to expensive, time-consuming, and needless arguments over theories that should not be raised.

3. The Proposed Penalty Structure Amounts to a Strict Liability Sanction on Most Tax Planning Activities

Despite its claim to the contrary, the JCT Study's substantial understatement penalty recommendations amount to a "strict liability" penalty on Covered Transactions.[60] As a preliminary matter, the penalty could not be waived or compromised by the IRS. Thus, IRS agents would be *obligated* to assert the penalty on all Covered Transactions when the IRS proposes a tax deficiency. As noted above, these recommendations, which are based on the JCT Study's definition of corporate tax shelters, encompass a range of legitimate tax planning activities which, in the corporate context, covers most transactions and many routine business operations.

Simply reciting the Joint Committee's proposed rules with respect to the ability to abate the substantial understatement penalty demonstrates their substantive and procedural complexity. To wit:

- If a taxpayer engages in a Covered Transaction that is a Reportable Transaction, it would be subject to a non-waivable forty percent penalty unless (i) the taxpayer wins on the merits or (ii) the taxpayer establishes that: (A) it properly disclosed the transaction, (B) it satisfied the seventy-five percent standard, and (C) the transaction served a Material Non-tax Business Purpose.
- If a taxpayer engages in a Covered Transaction that is not a Reportable Transaction, it would be subject to a non-waivable forty percent penalty unless (i) the taxpayer wins on the merits or (ii) the taxpayer establishes that: (A) it satisfied the seventy-five percent standard and (B) the transaction served a Material Non-tax Business Purpose.
- If a taxpayer engages in a Covered Transaction that is a Reportable Transaction (and does not win on the merits), the forty percent penalty would be reduced to a non-waivable twenty percent penalty only if the taxpayer can establish that (i) the taxpayer properly disclosed the transaction and (ii) the taxpayer satisfied the substantial authority (forty percent) standard.
- If a taxpayer engages in a Covered Transaction that is not a Reportable Transaction (and does not win on the merits), the forty percent penalty would be reduced to a non-waivable twenty percent penalty only if (i) the taxpayer can establish that (A) the taxpayer properly disclosed the transaction and (B) the taxpayer satisfied the substantial authority (forty percent) standard, or (ii) the taxpayer can establish that it satisfied the more likely than not standard.

What is important to note are the circumstances in which taxpayers will be subject to strict liability (*i.e.*, non-waivable) penalties if they do not prevail on the merits. Following are a few of the many striking examples:

- A corporate taxpayer engages in a Covered Transaction (i.e., a transaction that involves tax planning) that it fully discloses, under circumstances where it has a Material Non-tax Business Purpose and reasonably believes that it has a better than fifty percent—but less than a seventy-five percent—chance of prevailing in litigation. The corporation is subject to a non-waivable penalty unless it wins its case

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[59] Although the JCT Study would require only "a summary and analysis of the corporate participant's rationale and analysis underlying the tax treatment of the Reportable Transaction including the substantive authority relied upon to support such treatment," the reality of corporate tax practice and the advice provided corporate taxpayers by their tax advisors is that a corporate tax director will analyze *all* of the authorities that potentially apply to the purported tax treatment, including any contrary authorities and any authorities that an IRS agent might attempt to apply to disregard the purported tax treatment. In this regard, it is worth noting that the IRS always requires a taxpayer requesting a private letter ruling to identify and discuss any contrary authorities. *See* Rev. Proc. 99–1, 1999–1 I.R.B. 6.

[60] In contrast to the intent of the JCT Study, the Doggett Bill intentionally would create a strict liability penalty (*i.e.*, non-waivable penalties), with no exceptions for substantial authority or reasonable cause.

in court or obtains a greater than seventy-five percent concession from the government.[61]

- A corporate taxpayer engages in a Covered Transaction that is a Reportable Transaction under circumstances where reasonable tax professionals believe that the taxpayer has better than a seventy-five percent chance of sustaining the claimed tax treatment, and the taxpayer has a Material-Non Tax Business Purpose for engaging in the transaction. The taxpayer discloses the transaction, but omits certain of the information required by the disclosure rules. If the corporation loses the case in litigation, or concedes more than twenty-five percent of the issue in settlement, it will be subject to a non-waivable forty percent penalty.[62]
- A corporate taxpayer engages in a transaction under circumstances where it reasonably believes that it has a better than one-in-three chance of prevailing, but less than a four-in-ten chance of prevailing, and it fully discloses the transaction on its return. If the taxpayer does not prevail in litigation, the taxpayer will be subject to a non-waivable penalty of at least twenty percent.
- A corporate taxpayer will be subject to a non-waivable penalty with respect to Covered Transactions if it cannot convince the (undeniably reasonable) judge who has just decided the case against it that a reasonable professional would believe that the taxpayer had a better than seventy-five percent chance of prevailing.

The last example is one illustration of a more general point regarding the highly confident standard. The taxpayer can satisfy this standard only if it can establish that "a reasonable tax practitioner" would believe that the taxpayer had at least a seventy-five percent chance of prevailing on the merits. As a practical matter, this standard is unworkable. It means that the IRS revenue agent would have to conclude that proposed adjustment was proper, but that "reasonable tax practitioners" (including, presumably, the IRS revenue agent proposing the adjustment) would believe that the taxpayer had at least a seventy-five percent chance of prevailing. Likewise, it is difficult to envision an appeals officer settling an item by conceding less than seventy-five percent of the issue, yet concluding that the taxpayer had a better than seventy-five percent chance of prevailing. Finally, a court would have to conclude that the taxpayer was wrong on the merits, but that reasonable tax professionals (including, presumably, the judge hearing the matter) would believe that the taxpayer had a seventy-five percent chance of success. While all of this may be possible in theory, the practical effect is that the taxpayer will be liable for the penalty if the taxpayer loses on the merits.

Once again, the starting point is the breadth of the definition of Covered Transactions. These and other examples make it clear that the JCT Study's proposal amounts to a strict liability penalty on routine tax planning activities, and on the inevitable foot faults that will occur in complying with a complex set of rules. The fact that this is a strict liability standard in the "real world" is already acknowledged by the IRS: appeals officers are instructed to concede cases when the taxpayer has a better than eighty percent chance of success.

Two other practical implications of this regime are worth noting. First, as noted above, the JCT Study proposals would distort and undermine the settlement process. More fundamentally, while not stated in so many words, the JCT Study proposes going to a system where the only way that a corporate taxpayer can be certain to avoid penalties with respect to any item on its return is to pay taxes with respect to that item, file a claim for refund that is denied, and commence litigation in District Court or Claims Court.[63] In essence, the JCT Study is saying that when the outcome of a transaction that involves tax planning is less than certain, the taxpayer should overpay its taxes and sue for a refund.

While the many implications of this regime are beyond the scope of this paper, it is obvious that the JCT Study is recommending a far-reaching and fundamental change in our system of voluntary compliance and dispute resolution.

4. The Proposed Penalties on Tax Return Preparers, together with the Proposed Penalties on Third Parties Involved in Covered Transactions, Would Create Fundamental Conflicts of Interest Between Taxpayers and their Advisors

The JCT Study creates fundamental and irreconcilable conflicts between a taxpayer and its advisors. Quite simply, all return preparers, and all those involved

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[61] Presumably, when the IRS concedes more than seventy-five percent of an issue, the IRS would also concede that the taxpayer satisfied the highly confident standard.

[62] Presumably, when a taxpayer concedes more than twenty-five percent of an issue, the taxpayer will be hard pressed to convince the IRS that it satisfied the highly confident standard.

[63] This assumes that because the taxpayer will not owe additional taxes, it will not be subject to penalty—even if the taxpayer's claim is substantially or entirely without merit.

in advising corporations regarding Covered Transactions, have an overwhelming incentive to make certain that the taxpayer overpays its (his or her) taxes.

a. The JCT Study recommends penalties on tax professionals that will routinely exceed their net after-tax income. The JCT Study proposes increasing the first tier tax return preparer penalty to the greater of $250 or fifty percent of the preparer's fee.[64] The preparer can avoid this penalty only if: (i) the item satisfies the more likely than not standard or (ii) is properly disclosed and satisfies the 4-in–10 standard. It also recommends a penalty equal to the greater of $100,000 or fifty percent of the tax advisor's fees if the advisor directly or indirectly advises the taxpayer that it has a better than seventy-five percent chance of prevailing on the merits with respect to a Covered Transaction.

b. The JCT Study would authorize the IRS Director of Practice to impose further penalties on tax professionals, including sanctions that could prevent them from continuing to represent or advise taxpayers. While it is somewhat cryptic, the JCT Study appears to recommend that Congress: (i) provide specific statutory authorization for Circular 230; (ii) require that the IRS modify Circular 230 to conform to the JCT Study's recommendations (including but not limited to the corporate tax shelter proposals); (iii) define practice before the IRS to include the rendering of tax advice; (iv) require automatic referral to the Director of Practice whenever a preparer or advisor is subject to a penalty; (v) authorize the Director of Practice to impose monetary sanctions of up to one hundred percent of the fees received by preparers and advisors with respect to sanctioned conduct; (vi) authorize the Director of Practice to suspend or revoke the right of the preparer or advisor to practice before the IRS (including, the rendering of tax advice); and (vii) require the Director of Practice to notify the appropriate state licensing authorities if the advisor or preparer is subject to any sanction (including, a letter of reprimand). While not entirely clear, it appears that tax professionals could be liable for both the preparer penalties and Circular 230 monetary sanctions in connection with the same transaction.

In other words, the Code-based penalties on preparers and advisors could well amount to more than one hundred percent of their after-tax income.[65] Under circumstances where these penalties are triggered, the preparer or advisor must be referred to the Director of Practice who has the authority to impose another penalty equal to more than the preparer's or advisor's pre-tax/pre-Code penalty income. Not to mention the fact that the Director of Practice can take away the preparer's or advisor's future right to make a living as a tax professional, and the fact that if the Director so much as issues a letter of reprimand, the preparer or advisor must be prepared to defend himself or herself before state licensing authorities.

With this penalty and sanctions structure as background, it is worth revisiting when advisors and preparers will be subject to the Code-based penalties and the chain of events that those penalties will trigger:

- All return preparers (including those representing non-corporate taxpayers, and including those representing corporations on matters that are not Covered Transactions) are subject to a penalty if the return position has a less than forty percent chance of success on the merits.
- All return preparers are subject to a penalty if the return position has a forty percent or greater chance of success, but less than a fifty percent chance of success, unless the item meets the applicable disclosure rules.
- All those involved in advising a corporate taxpayer are subject to a penalty if they advise the taxpayer with respect to a Covered Transaction (i.e., routine tax planning activities) that it satisfies the highly confident standard under circumstances where the taxpayer ultimately does not prevail on the merits.[66]

When all of these proposals are viewed together, it is clear that preparers and advisors have overwhelming incentives to: (i) make certain that taxpayers call every close question (and most not-so-close questions) in favor of the IRS; (ii) make certain that taxpayers disclose questionable items and make certain that the disclosure is overly broad; (iii) encourage taxpayers to overpay their taxes and sue for refunds; and (iv) document their communications with their clients in a way that serves their

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[64] The JCT Study also recommends increasing the second tier penalty to the greater of $1,000 or one hundred percent of the preparer's fees.

[65] *See supra* footnote 11.

[66] The advisor penalty is a strict liability sanction for two reasons. First, as noted above, advisors are subject to an even higher "highly confident" standard than corporate taxpayers (advisors apparently fail to satisfy this standard if even one reasonable professional would conclude that the taxpayer had less than a seventy-five percent chance of succeeding on the merits). Moreover, as noted above, there is no realistic possibility that a court would decide against the taxpayer and then conclude that all reasonable tax professionals believed that the taxpayer had a better than seventy-five percent chance of success.

own best interests, and to disclose client confidences as a means of defending against penalty assertions.

THE JCT STUDY'S PROPOSALS VIOLATE ALL FOUR CRITERIA THAT SHOULD BE USED IN EVALUATING LEGISLATIVE PROPOSALS TO ADDRESS CORPORATE TAX SHELTERS

1. The Recommendations Made in the JCT Study Would Interfere With Mainstream Business Transactions and Ordinary Tax Planning Activities

While the JCT Study sets forth comprehensive and well-intended proposals for fundamental reform of the rules governing taxpayer compliance, we believe that significant issues exist with these proposals and that they would benefit from further review. For a number of reasons, the JCT Study's proposal would inhibit routine business transactions and customary tax planning activities. Most obvious, of course, are the administrative costs, reporting burdens and strict liability penalties that would be imposed on corporate taxpayers. The underlying definition of Covered Transactions is so broad, and the sanctions are so draconian, that taxpayers will minimize their costs and their risks by simply not engaging in widely accepted, and entirely appropriate, tax planning activities.

The less obvious, but equally important reason, is that preparers and advisors have an overwhelming incentive to discourage tax planning under circumstances where their risks are substantially disproportionate to their potential benefits. The JCT Study asserts that tax professionals have a dual responsibility to their clients and the tax system. The practical effect of the JCT Study's recommendations is to require that preparers and advisors show single-minded devotion to the IRS. It is inevitable that under this regime taxpayers will not engage in entirely appropriate tax planning activities—unless they are big enough, and have sufficient cash, to internalize the process and routinely engage in refund litigation.[67]

The question posed above was whether the White Paper and JCT Study recommendations would impede legitimate tax planning. The answer to that question is unequivocally yes.

2. The Recommendations Made in the JCT Study Would Impose Needless Complexity

The rules recommended in the JCT Study are overly complex for a multitude of reasons, including the following:

- They raise difficult questions of substantive interpretation and application (what is a Covered Transaction, is a Covered Transaction a Reportable Transaction, is disclosure required, is the disclosure adequate, are the taxpayer's odds of success 74% or 76%, 49% or 51%, 39% or 41%).
- They codify a two-tier audit system: the correctness of the taxpayer's return and the taxpayer's compliance with disclosure rules and penalty provisions.
- They create "cliff" effects that the tax system should avoid (the taxpayer's liability for penalties can fluctuate dramatically depending upon a one percent swing in its chances of success).
- Given the scope of Covered Transactions, the disclosure and certification requirements are extremely burdensome.
- They place a premium on needless documentation of routine transactions and activities by taxpayers, preparers and advisors.
- The 30-Day Disclosure requirement is extremely burdensome and entirely unnecessary.
- They impose significant practical barriers to the settlement of most tax disputes.

3. The Recommendations Made in the JCT Study Violate Basic Notions of Fairness and Equity

The recommendations made in the JCT Study, which was written in response to a congressional request for legislative recommendations to simplify penalty or interest administration and reduce taxpayer burden, violate fundamental notions of neutrality and fair play in many respects.

- For the reasons explained above, they create a structural bias that will cause taxpayers to systematically over-pay their taxes.
- They arm IRS revenue agents, appeals officers, and attorneys with the weapons to extract inappropriate concessions from taxpayers (both directly, and through

[67] As noted above, The JCT Study implicitly stands for the proposition that taxpayers can engage in any type of tax planning they choose—but only if they are willing to pre-pay their taxes and sue for a refund. It seems apparent that this construct will, in the real world, materially inhibit legitimate tax planning.

pressure on taxpayer representatives). It is absolutely certain that these weapons will be used improperly by some IRS employees (because they don't understand the rules or are overzealous).

- The proposals permit the government to avoid accountability for the rules that it writes. As both the JCT Study and the White Paper acknowledge, many of the transactions targeted by their recommendations result from the complexity of the Code and attempts to exploit inconsistencies in the tax law.[68] The White Paper and JCT Study proposals reduce any incentive that the government might otherwise have to write neutral rules and simplify the tax system.
- The proposals impose standards on taxpayers and third parties that are far more onerous than the standards imposed on the government. The JCT Study and the White paper emphasize the importance of the public's confidence in the basic fairness of the tax system. One sure way to destroy this confidence is to impose onerous requirements on citizens that the government refuses to live by. The White Paper and JCT Study proposals violate this fundamental norm of good government. To cite a few examples, IRS agents can assert frivolous positions against taxpayers with no consequences to the institution or the individuals involved. IRS attorneys can advise their IRS clients to take frivolous positions against taxpayers with no financial or professional consequences to them. The IRS can issue 30-day and 90-day letters challenging Covered Transactions that do not include the information required of taxpayers in their disclosure statements. The District Director is not required to certify under penalties of perjury that a 30-day or 90-day letter challenging Covered Transactions is true, accurate and complete. The courts are instructed to enjoin the marketing of a Covered Transaction even when the IRS has no realistic possibility of success on the merits.

For these and other reasons, the response to the third question is also yes. The White Paper and JCT Report do violate basic notions of fairness and equity.

4. The Recommendations Made in the JCT Study Would Result in Arbitrary and Hidden Tax Increases

The White Paper and JCT Study proposals amount to an arbitrary and hidden tax increase for all of the reasons noted above. Taxpayers are given strong incentives to over pay their taxes, and preparers are given stronger incentives to make sure that happens. The IRS is given weapons to extract inappropriate concessions from taxpayers, and preparers are given incentives to make certain that taxpayers go along.[69] Not only would the proposals result in a tax increase, they would result in the worst kind of tax increase—one that is not transparent, is not neutral, and can be arbitrarily imposed by individual employees of the government.

The proposals would also result in a second kind of equally troublesome tax increase in the form of increased dead-weight compliance costs. While these costs are not technically "tax increases," they have the same practical effect.

CONCLUSION

There is no evidence that corporate tax shelters are severely eroding the corporate tax base. While concerns have been expressed, the IRS is pursuing enforcement efforts, including the assertion of penalties, and the courts have sided with the IRS in a number of well-publicized cases. The Treasury Department is issuing regulations (including retroactive rules) to address transactions that it finds troublesome.[70] At some point, the IRS and the Treasury Department will implement the tax shelter registration legislation that was enacted in 1997. The audit cycles for returns filed after the enactment of the changes made in 1997 to the penalties with respect to corporate tax shelters will begin in the next several years. IRS agents are increasingly making use of recent IRS court victories to attack transactions on

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[68] *See* JCT Study at 207; White Paper at 17. For example, both the installment sale transactions and the transactions involving transfers of property subject to liabilities, which are identified as examples of corporate tax shelters by the JCT Study and the White Paper, involved attempts to exploit inconsistencies in the tax law and the IRS's interpretation of complex rules.

[69] One way to illustrate this point is to use the JCT Study's own assumptions regarding behavior. If the proposals are successful in assuring that taxpayers generally take taxpayer-favorable positions only when their chances of success are forty percent or greater, and generally engage in Reportable Transactions only when their chances for success are greater than seventy-five percent, then taxpayers will necessarily over pay their taxes. This is especially true under circumstances where the IRS can (and routinely does) assert claims when it's chances of success range from zero to forty percent.

[70] Moreover, even when the Treasury Department is not certain whether a transaction is troublesome, it increasingly attaches broad anti-abuse rules to otherwise objective regulations. *See, e.g., Treas. Reg.* § 1.367(e)–2(d) (establishing broad anti-abuse rule authorizing the IRS to require gain recognition on otherwise tax-free liquidations "when a principal purpose of the liquidation is the avoidance of U.S. tax").

economic substance and similar grounds.[71] These developments are of relatively recent vintage, and will likely begin having an impact on taxpayer behavior. Under these circumstances, we do not believe that the case has been made that more legislation is necessary at this time.

There are some who believe that the pendulum is already starting to move in the other direction, and that the primary challenge facing IRS executives and the Congress will be reining in overzealous enforcement and litigation activity by the IRS. In particular, as the courts place more reliance on the "common law" doctrines described in the JCT Study, there is an increased risk that the IRS will move away from the "rules based" system that the JCT Study endorses. In this regard, it is already clear that IRS agents are starting to rely on these common law principles in situations that are wholly inappropriate and at the expense of the rules that have been crafted by the Congress.[72]

Moreover, we believe that legislation would be ill-advised because the risks are high that the proposals advanced to date would do more harm than good. This concern is compounded by the realities of the legislative process. If the Congress enacts legislation that leads to the adverse results that we and others anticipate, revenue estimating conventions and the budget process would prevent the Congress from undoing the damage. Indeed, the worse the adverse impact, the more difficult it would be to remedy the situation.

Accordingly, we respectfully recommend that the Congress instruct the Treasury Department to promulgate the regulations that were required in 1997, and to identify specific areas of the substantive tax law in which changes may be necessary. Moreover, we recommend that the Congress instruct the IRS to develop a system of obtaining statistically valid quantitative data to indicate where the IRS should focus its enforcement efforts and where there are defects in the tax system that require legislative action. In addition, to make certain that the IRS has the resources it needs to make use of the tools already available to it, Congress should continue to provide adequate funding to the IRS (as it already has for the current fiscal year).

[71] *See, e.g.*, T.A.M. 199934002 (May 24, 1999) (applying *ACM Partnership* and similar authorities to conclude that the taxpayer's nontax motives for securing its promises to pay employee benefits lacked sufficient economic substance to cause them to be respected for Federal tax purposes).

[72] *See, e.g.*, FSA 199935019 (June 1, 1999) (IRS National Office instructed agent that *ACM Partnership* and other economic substance cases were not applicable to transactions involving contributions to capital); T.A.M. 9818004 (December 24, 1997) (IRS National Office refusing to revoke a letter ruling allowing the taxpayer to change its method of accounting for service contracts, finding that *Ford Motor Co.* was not applicable).